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BOOK REVIEWS

Case Studies in Auditing Procedure No. 9 —A Wholesale Distributor of Newspapers and Magazines

Published by the AMERICAN INSTITUTE OF ACCOUNTANTS, New York, N. Y., 1951. Pages: 46; single copy 50¢, reduction of 10¢ for orders of 10 or more copies, special price of 25¢ per copy to accounting students enrolled in recognized colleges or schools.

This is another study in the series which sets forth auditing procedures which have been actually used in carrying out an audit engagement.

The material is arranged under the following general headings:

- Description of business
- Accounting records
- Major accounting policies
- Review of internal control
- General audit procedures
- Conclusion

In a well balanced and readily followed presentation, this study includes a description of the business activities in detail and a wealth of information as to the accounting records and procedures employed.

A helpful feature of the arrangement of the pamphlet is the separate treatment of the auditing procedures used to test the accounting sysetm or internal control from those employed to substantiate year-end balances. Additional clarity is achieved by showing under each subheading, such as "cash receipts", "accounts receivable and sales", etc., first a description of the procedures used, followed by an outline of the auditing procedures applied to that section of the system.

A summary of the distribution of the audit work throughout the year, the amount of time required, and the classification of staff used on the engagement, is included.

This study leaves few questions unanswered as to the business activities, accounting records maintained and methods followed, and auditing procedures used. It should prove as helpful to those interested in the accounting system and controls for a business of this type as to those concerned with the auditing of such an enterprise.

JOHN F. SCHMONSEES

Hurdman & Cranstoun
New York, N. Y.

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BOOK REVIEWS

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Economic Effects of Section 102

Published by the TAX INSTITUTE, INC., Princeton, N. J., 1951. Pages: xxiii + 314; $5.00.

It is a left-handed tribute to the penalty tax on the unreasonable accumulation of profits that the section of the Internal Revenue Code under which it is imposed can be cited in the title of this volume with full assurance that the reader will be thus apprised of its contents. No other section of the Code could be referred to so familiarly, and this despite the fact that cases arising under Section 102 are relatively few and far between.

For many years, tax practitioners and taxpayers have annually invoked the oracles for guidance as to whether or not and to what extent dividends should be declared in order to avoid falling afoul of Section 102. The invocations were measurably intensified by the famous question on the 1946 return asking about dividend payments. Because of the widespread discussion of this question, the Tax Institute undertook the task of assembling facts bearing on the actual impact of Section 102 on the actions and policies of corporations and to present the opinions of various tax experts on possible revision of the Section.

The Tax Institute is a nationwide research organization with headquarters at Princeton, New Jersey. In order to clarify difficult problems, the Tax Institute conducts panel discussions by experts representing different points of view. To explore the effects of Section 102, a questionnaire was mailed to selected tax practitioners, followed by a fact-finding panel and a policy discussion panel. The study was inaugurated in 1949 when Mr. J. K. Lasser, C.P.A., was president of the Tax Institute and the panels of experts were presided over by Mr. Edwin B. George,

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BOOK REVIEWS

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Director of the Department of Economics of Dun & Bradstreet. This volume summarizes the results of the questionnaire and reproduces *verbatim* the discussions which took place on both panels. Recognizing the inherent sprawling nature of a work which seeks to reflect the views of the two hundred practitioners who responded to the questionnaire, and the discussions, in good part extemporaneous, of the two dozen experts who constituted the panels, the volume includes a comprehensive synopsis of the views expressed together with a detailed index. There is also included an extensive bibliography covering all phases of Section 102 ranging from the legislative history of the section to its effect on key-man life insurance.

What are the economic effects of Section 102? Probably the most universal effect noted was the fear and uncertainty caused by the provision with consequent pressure to undertake unbusinesslike actions such as unwise or premature expansion and excessive merchandise purchases or commitments. Other effects noted were the use of debt rather than equity financing, and the sales and mergers of corporations resulting in the concentration of business enterprise.

There appeared to be a general appreciation by the policy panel of the reasons for the existence of Section 102, so that a majority of the panel did not recommend repeal. A majority of the panel felt that, without undue damage to the purposes of the section, certain changes could and should be made. Thus it was the majority feeling that the Commissioner should stipulate more clearly the reasons justifying the retention of profits; that the burden of proof be on the Commissioner to prove unreasonable accumulation; that a business be allowed to accumulate against foreseeable future needs and not be restricted to immediate projects; that a business be allowed to accumulate funds based on replacement costs of depreciating property; that dividends paid within two and a half months after the close of the taxable year be considered in applying Section 102; and that a credit of 90% be allowed against the amount of a deficiency if distribution is made within ninety days of filing of the notice.

Being a wide survey of the thoughts of active and expert tax practitioners and containing also a fine bibliography, this book can, in addition to its stated purpose of assessing the operation of the section, be of value to one called upon to deal with a specific Section 102 situation.

OSCAR HANIGSBERG

New York, N. Y.

Codification of Statements on Auditing Procedure

Based on Statements 1 to 24 (1939 to 1949). Issued by the Committee on Auditing Procedure of the American Institute of Accountants. AMERICAN INSTITUTE OF ACCOUNTANTS, New York, N. Y., 1951. Pages: 59; $1.00.

This is a codification of the more valuable and currently useful features of the 24 Statements on Auditing Procedure. As a result, Statements Nos. 7, 9, 10, 15, 17, 20 and 21 have been omitted from the summary, because the material contained in them applies only to special situations. Important substantive changes were also made in Statements 1, 3 and 12 to give effect to an additional conclusion reached by the committee in the areas of inventory observation and confirmation of receivables, as well as to Accounting Series Releases Nos. 62 and 70, issued by the SEC.

The Appendix contains material on Case Studies in Inventories; Confirmation of Public Utility Accounts Receivable; References to the Independent Public Accountant in Securities Registrations; Clients' Written Representations Regarding Inventories, Liabilities, and Other Matters; and a List of Statements on Auditing Procedure.

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THE NEW YORK
CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

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Economic Factors in Selecting LIFO

By ALFRED C. BONI

In this paper, a consulting economist attempts to weigh the advantages and disadvantages of LIFO for manufacturing enterprises having a fairly frequent inventory turnover and an average normal ratio of year-end stock to total investment. He endeavors to assess the relation of the firm's use of the LIFO method to its profitability from the viewpoint of the distant prospects rather than the near-term probabilities. He concludes that weighing LIFO on the economic scales is a process that well repays the effort when applied to concrete business situations but leads to no generalized judgment on the merits of this method of inventorying.

ALFRED C. BONI, President of Boni, Watkins, Mounteer & Co., Inc., New York, has, since 1924, been engaged in financial and economic research. In 1933 he collaborated in the preparation of an economic study for the U. S. Supreme Court in connection with the "gold-clause" cases. In 1924, at the instance of the General Counsel of the War Shipping Administration and certain private transportation interests, he appeared as an economist and valuation expert before the President's Advisory Board on Just Compensation composed of Circuit Court Judges Hand, Parker and Hutcheson. On other occasions he has testified on economic matters before various courts and administrative bodies.

This paper was presented by Mr. Boni at a technical session of the 18th Annual Conference of the Society, held at Saranac Inn, New York, on June 26, 1951.

I. Introduction

An economist contributing to a symposium on LIFO must first of all select his approach to the problem. Otherwise he runs the risk either of treading on the toes of someone else or, by attempting to cover too much ground, of accomplishing nothing. In selecting an approach, however, he has a wide range of choice. He might consider the implications of LIFO from the standpoint of its bearing on how the national economy operates, and in particular on its stability. Or he may weigh the advantages and disadvantages of LIFO for certain broad classes of industry, less concretely than, but in much the same way that, he does for specific clients in the ordinary course of professional practice. On this score, we shall here discuss the issues from the latter standpoint.

Again, he may analyze LIFO's debits and credits in the short run or in the long run, using, as it were, either his reading spectacles or his out-of-doors spectacles. In this respect,

we shall not confine ourselves exclusively to one choice or the other. But we shall focus primarily on the distant prospect rather than on near-term probabilities.

Finally, election of the LIFO method of inventorying has many aspects, affects a business in numerous ways—for example, its tax burden, its administrative overhead, its purchasing policies, its financial reporting procedures, etc. So an economist might attempt, on an occasion like this, to present an integrated digest of — in accordance with the foregoing limitations — primarily, LIFO's long-term economic implications, from all angles, for certain types of business. Or he may deliberately restrict his approach to a single aspect, or a definite segment of the whole problem. In this respect our choice is, in effect, determined for us. Your program committee having assigned several specific aspects of the subject to other speakers, we shall try to avoid invading their provinces. Our concern will be to assess the relation of a firm's use of the LIFO method to its profitability. And in the main we shall have in view, not a mercantile concern, but, a manufacturing enterprise and, moreover, one assembling and fabricating semi-finished materials or parts, so that its inventory turnover is fairly frequent and the normal ratio of its year-end stocks to total investment is neither inordinately high nor exceptionally low.

So delimiting our remarks does not mean, of course, that we can now safely ignore such vital matters as the accounting aspects and the tax aspects of LIFO altogether. It would be quite misleading if we were to give the impression that one can weigh LIFO on the economic scales in a vacuum, so to speak. In practice, a decision as to whether it will be profitable to adopt the LIFO method often turns very largely on the question of the magnitude of the tax savings it would realize or of the accounting difficulties and reporting complexities that might ensue. For present purposes, therefore, we simply take these "other factors" for granted, even though they are in no sense non-economic factors, and inquire how the impact of LIFO on a firm's profitability may be affected by external economic conditions quite independently of the particular framework of existing tax rules and patterns of accounting procedure.

While changes in the economic environment of a business may be of innumerable varieties and affect it in countless ways, it will suffice here to concentrate attention on two types of change that radically affect the outcome of the use of the LIFO method. These are: Movements of the general price level and the advance of technology. Prices can move either up or down. Technology moves only forward. These types of change differ in other respects, too, but this difference alone would warrant their separate discussion.

II. Role of Price Movements in a Decision For or Against LIFO

The great virtue of the LIFO method of inventory valuation is that, as compared with alternative methods, it effects a determination of the cost of goods sold more nearly corresponding with their actual current cost of replacement. Thus it ordinarily tends to stabilize cost-price relationships, to reduce fictitious inventory "profits" and exaggerated inventory "losses", and to even out fluctuations in *reported* earnings. Of course, no method of inventory valuation, any more than any other accounting procedure, can *by itself* alter the actual profitability of a firm's operations. That is determined by the terms of purchase and sale transactions themselves, and methods of recording and reporting them have no *direct* effect thereon.

But as everyone knows they can have and usually do have a profound *indirect* effect on purchasing and selling policies and hence on a firm's profitability. For the size and complexity of most modern business units make management ut-

terly dependent on record-keeping. So managerial decisions are bound to reflect what the records show—or seem to show! As accounting procedures and the form in which the books are kept largely determine what the records show, it is clearly imperative that they be designed to report, as nearly as possible, existing conditions. For without realistic accounting records and financial reports based thereon, managerial policies will be unrealistic. And to the extent that managerial policies are based on illusions rather than on the real facts of the situation, the firm's transactions will fail to accomplish what we assume to be their objective: the maximization of the long-run profits of the business.

LIFO contributes to the achievement of this goal. It starts from the premise that normal inventories are not "for sale", that working capital in this form is part of the necessary investment of a going concern. Just as the maintenance of capital invested in fixed assets requires provision, out of current revenues, for the *cost of replacement* of specific items of plant and equipment as they wear out or become obsolete, so the maintenance of capital invested in stocks of materials, work-in-process, and finished goods requires a charge against current revenues for the *cost of replacement* of these semi-liquid assets. LIFO does this. It does it when prices are going up, and it does it when prices are going down. Any inventory accounting device that does not do this, that obscures or overstates or understates the replacement cost of stocks used up or disposed of during the accounting period, inevitably tends to mislead management. In such circumstances, if the profitability of the enterprise does not suffer it can only be thanks to fortuitous good luck.

Once these fundamental economic principles are firmly grasped the significance of price level changes as a factor bearing on the election of LIFO can be better appreciated. Much of the discussion of this subject has proceeded on the implicit assumption that the rise and fall of prices cancel out. Probably this is traceable to preoccupation with the business cycle, over the past quarter century, of both economists and businessmen. The study of its mechanism and the attempt to forecast cyclical turning points have been for a generation, one might almost say, the great American pastime. At any rate, the counterpart of concentration on the vicissitudes of cyclical fluctuations has been a general neglect of the secular course of prices—which in our judgment is a far more significant phenomenon in the present context.

The fear lest adoption of LIFO coincide with a price "peak", thereby leading to an over-valuation of current assets in the balance sheet, and to higher earnings levels and larger taxes than would otherwise be indicated, has in our judgment obstructed the shift to LIFO more than the actual risks involved warrant. This judgment rests on three grounds.

First, even though the balance sheet picture of a company's financial position may, in such circumstances, be distorted, the income statement continues to reflect accurately the concern's actual operative efficiency. And as a basis for managerial decisions on current operating policies the income statement is far more important than the balance sheet. Moreover, in a period of declining prices the LIFO method leads to lower materials cost, in the computation of the "cost of goods sold", than the conventional "lower-of-cost-or-market" method of inventorying. Hence use of LIFO in such a period gives the user a competitive advantage in respect to choice of selling policies in the current market.

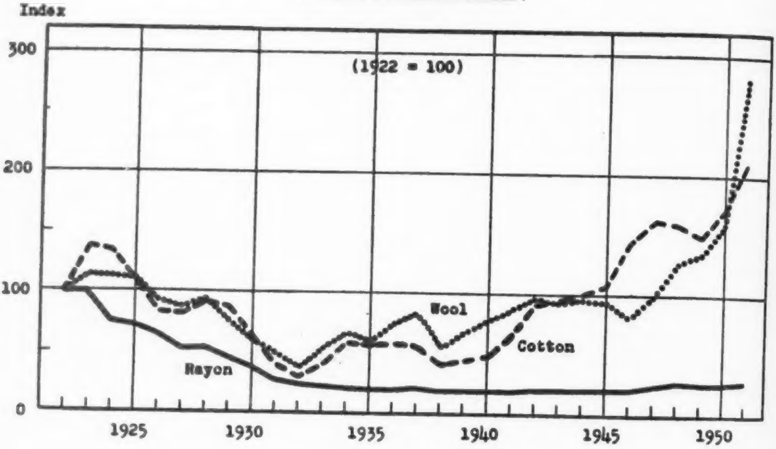
Secondly, while it is true that a company which has adopted LIFO at a price-level "peak" cannot effect income tax savings in the ensuing period of declining prices by offsetting against current income "bookkeeping losses" on its normal stock carry-over, it should not be overlooked that this is not an un-

Chart 1

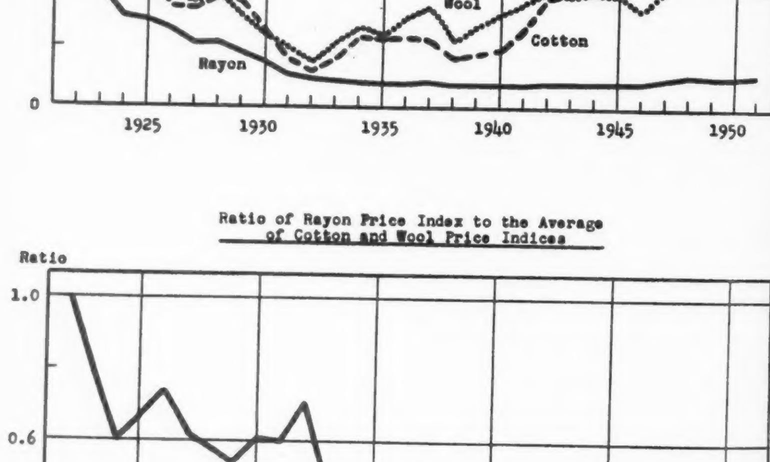
COMPARATIVE PRICE TRENDS OF RAYON, COTTON AND WOOL

1922 THROUGH 1951*

Indices of Annual Prices



Ratio of Rayon Price Index to the Average of Cotton and Wool Price Indices



* First four months of 1951

mitigated disadvantage. Thus, though its income *subject to tax* will be higher in the declining price period than it would otherwise be, the *income-tax rate* to which it will be subject is almost certain to be lower than the rate applicable to its presumably higher taxable income in the year of the adoption of LIFO and in the prospective period of rising prices after the "recession" is arrested. For the general experience has been that corporation income tax rates move with commodity prices (Chart 1). And as a basic assumption behind the fear of electing LIFO at a price "peak" is that ups and downs of prices are compensatory it follows that, on this assumption, LIFO still offers a balance of advantage taxwise.

The third ground for discounting the risks of a tax handicap from election of LIFO at a time when the price cycle is turning downward goes to the roots of the economic environment of American capitalism. My thesis here has many facets, adequately to develop all of which would take us far beyond the compass of a symposium paper. I shall attempt no more than to indicate briefly the elements of our present position which, in my view, point unmistakably toward a persistent, long-run, upward trend of prices for as far ahead as it is worth any businessman's time and trouble to plan for.

1. The secular rise in prices which has characterized the past half-century shows no sign of abatement. Indeed the threefold rise over this period was comprised, roughly, of a 50 per cent advance in the first four decades of the century and a 100 per cent advance in the next decade. This rate of acceleration in the upward movement need not, probably will not, continue. But at least it suggests that a movement that has gained such headway is unlikely to be suddenly reversed, in so far as the long-run trend is concerned, though intermediate drops, even precipitate ones of distressing magnitude, are by no means ruled out (Chart 2). Moreover, the fact that gold is undervalued in the monetary system of practically every important trading country in the world, and in particular at the United States Treasury's buying price of $35.00 an ounce, certainly lends no support for the view that prices have reached a twentieth-century "top".

2. The radical change that has taken place in the position of the United States as a world power has brought fiscal burdens commensurate with its increased international responsibilities ——and perplexities. Current developments, alike in respect to our own rearmament, to the strengthening of both the will and the military power of our allies, and to the economic up-building of under-developed regions, all point toward a long-continued heavy drain on American resources, with attendant difficulty of keeping public finances in balance. And with a federal debt already raised to more than $250 billion, primarily by the exigencies of two world wars, not much leeway is left for non-inflationary expansion of the public revenues required by our existing commitments and plainly unavoidable international obligations. In these circumstances, unbalanced budgeting and dilution of the currency through borrowing not matched by real savings is more than a speculative possibility. It is a realistic probability.

3. Perhaps the most important factor of all bearing on the prospect of a continuing secular upward trend of prices is the change in the climate of opinion and in the balance of social and political forces in recent decades. This may or may not be "the century of the common man", but it has certainly witnessed a social transformation and a political reorientation of which the nineteenth century, at least in America, provides no parallel. The remarkable growth in the power and influence of organized farmers and wage-earners and their insistent demands for economic safeguards and social security have made quite inconceivable any reversion to a pattern of monetary policy

Chart 2

CORPORATE TAX RATE VS. COMMODITY PRICES
1917 THROUGH 1950
(in standard deviation units)

* Tax rate in bracketed years based on actual normal and surtax income tax rate plus derived effective rate for excess profits taxes.

which will ever again, in our day, permit prices "to seek their own level." Furthermore, not only has this change in the temper of popular opinion been reflected in the whole gamut of New Deal legislation and postwar public policy, with its continuing emphasis on governmental planning, provisionment, and guarantees, but also it has coincided with a similar change in the climate of opinion among professional economists. What has frequently been referred to as "the Keynesian revolution" in economic thought obviously gives added weight to the demands of the lower and middle classes for a larger and better assured share in the distribution of income as well as for a more aggressive use of governmental powers to control prices. Uninhibited by traditional norms of sound finance, the Keynesians have been ready enough to lend their support to any program that seems, for the nonce, to promise uninterrupted "full employment" and "high level consumption". The upshot is, as we are seeing today, that effective anti-inflationary measures are outside the realm of practical politics.

In view of all the foregoing considerations I submit that, by and large, the danger of adopting LIFO at a cyclical "peak" of the price level has been appreciably over-stressed. This conclusion does not mean, of course, that it would not be preferable to elect LIFO at the low point of an ebb tide of cyclical price fluctuations. Everyone recognizes, with the advantage of hindsight, that a 1940 or 1941 election would have been more advantageous than a 1950 or 1951 election could be. But the conclusion does mean that it is economic folly to be so intent on avoiding short-run disadvantages as to sacrifice long-run advantages that would more than offset them. It should hardly need emphasis here that I am not contending LIFO's long-run advantages will, in all circumstances, for every firm, outweigh the risk of short-run disadvantages. What I have attempted to do is simply to present that risk in what seems to me a just and realistic perspective. The next section will indicate that though the risk of long-run disadvantages can easily be—and often has been—exaggerated, it is none the less real.

III. Role of Technological Changes in a Decision For or Against LIFO

If decisions regarding the election of LIFO have been, for the most part, unduly influenced by the risk of introducing it at the crest of a cyclical price movement, they have been insufficiently influenced in many cases, we venture to suggest, by the risk of technological obsolescence forcing the liquidation of specific inventory components. Inventory liquidation on this account must almost invariably be effected at a substantial sacrifice in terms of unit prices, of course, regardless of the current level of prices in general relative to that prevailing at the time of LIFO's adoption. Moreover, the novel (and it may be assumed, for present purposes, superior) materials or products that an advancing technology makes available will ordinarily be taken into inventory at prices which, just because of the novelty and relative scarcity of these items, are substantially inflated. Hence, under the LIFO method of inventorying a firm's stock is likely to be "loaded" indefinitely with components exceptionally high-priced relative to their normal price, or long-run cost of production.

The peculiar vice of the LIFO method, from this standpoint, springs mainly from the technical, administrative requirement of substantial homogeneity of inventory categories for manufacturers electing this method. This, as all of you know, is a vexing question with a long background, and I do not propose to go into it extensively here. Suffice it to say that though the dollar-value method of LIFO inventorying, with costs adjusted by a suitable price-index formula, has now at long last, by T. D. 5756, been authorized for general use, in actual application it affords manufacturers no such safeguards against inventory losses

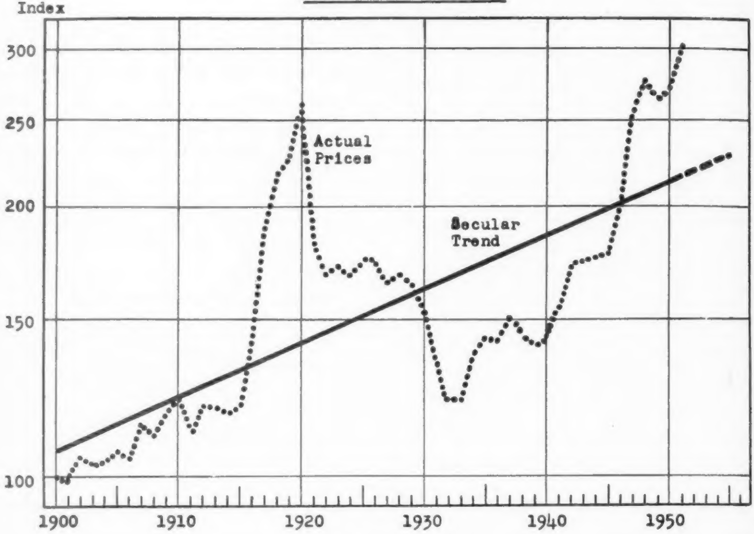
Chart 3

INDICES OF FINISHED GOODS AND RAW MATERIALS PRICES
AND SECULAR TRENDS THEREOF

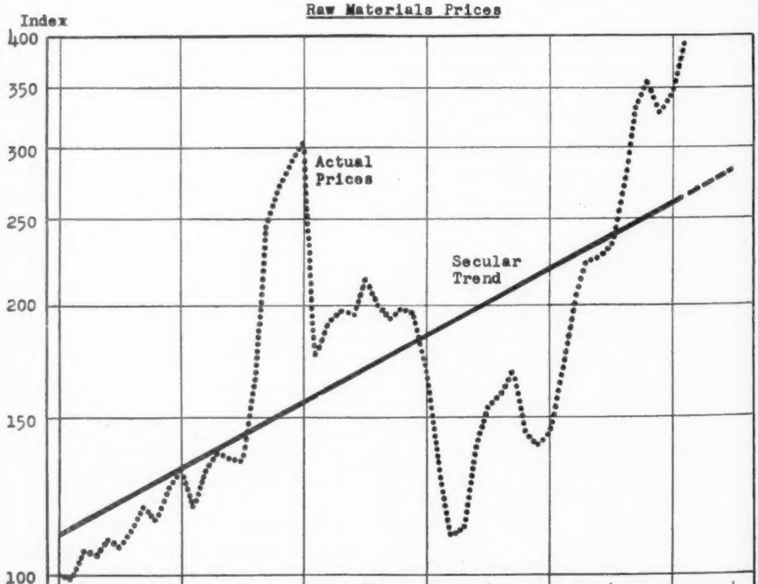
1900 THROUGH 1951*

(1900 = 100)

Finished Goods Prices



Raw Materials Prices



* First four months of 1951

from technological obsolescence as those T. D. 5605 affords department stores against inventory losses from, for example, style changes. If manufacturers were permitted to group, or "pool", diverse inventory items of materials and parts related only by their common destination in a single broad product category, in much the same way that retail stores are permitted to maintain department-wide inventory categories, the contingency of their incurring heavy, lump-sum inventory losses due to technological obsolescence would be practically obviated. But despite the gradual relaxation of classificatory rigidity in administrative interpretations of T. D. 5407, and more recently of T. D. 5756, there appears to be no immediate likelihood of "the bars being let down" to a general extension, in a thoroughgoing way, of the principle of the *Hutzler* case, acquiesced in by T. D. 5605. In these circumstances it would seem prudent to predicate any decision with regard to LIFO on the premise of continued administrative insistence on substantial homogeneity in respect to physical characteristics of the materials items includible in a single inventory category.

Like the risk discussed in the preceding section, the risk of disadvantage from enforced inventory liquidation due to technological obsolescence is associated with a price decline to a level below that prevailing when LIFO was adopted. But there the similarity ends. Whereas a change in the general price level may be either up or down and, in whichever direction, affects every business, indeed every phase of a firm's activities, technological obsolescence leads only to price declines and as a rule, nowadays, such declines affect no more than a small phase of a going concern's entire range of operations.

It is of the essence of the risk of a technologically induced inventory liquidation that such a contingency is sporadic and inherently specific. And because the LIFO method, under existing rules of application, necessarily entails a narrow classification of inventories, there is slight opportunity for following the insurance principle of spreading out the risk. Hence the only safe course is to assess carefully, in advance, the risk of each item in a firm's stock of materials being superseded by some new technical development. In our judgment, adopting LIFO without first making such a detailed survey is extremely hazardous—more hazardous than is generally appreciated.

Of course, not every business, nor every department of any business, is subject to the same degree of risk in respect to technological obsolescence of its inventories. Broadly speaking, the industries most exposed to this contingency are the newer ones. Firms in two segments of the economy appear to be especially vulnerable on this score, those producing chemicals and those engaged in manufacturing electronic equipment, as well, of course, as the numerous companies directly or indirectly dependent upon or tributary to either of them.

To illustrate the foregoing points, between 1939 and April 1951, the all-commodities wholesale price index rose approximately 138 per cent, while that of chemicals rose only 63 per cent.* Again, the price history of synthetic fibers as compared to that of natural fibers readily comes to mind in this connection. By reference to the chart which I have here (Chart 3) you will observe that between 1922 and 1951 rayon prices declined absolutely and relatively to those of both cotton and wool. However, at the moment the prospects of comparative price movements in the textiles field again require revaluation. Techniques for the production of rayon are fully developed; they have remained virtually unchanged in the past decade, with no sign of any radical improvement impending. Nor is there any prospect of raw material prices of cellulose-based synthetics declining disproportionately to the prices of raw

* Based on Bureau of Labor Statistics indices.

materials in general. Indeed, the prospect is for an exactly opposite movement, with the depletion of readily accessible timber sources already strikingly reflected in the wood-pulp market and all its tributary markets, most notably that of newsprint.

On the other hand, interestingly enough, the present prospect is for a sustained downward trend in the prices of the newer synthetics such as Nylon, and even more of Orlon, Vinyon, and Dynal relative not only to the general price level but also to prices of rayon and other, older textiles. This is because the known technical difficulties in compounding some of these newer synthetics will no doubt be surmounted and, secondly, because others, still in an experimental stage but almost certain eventually to reach commercial production, will by their competition force producers to operate on narrower margins.

In summary, any firm operating in new fields should "look twice" before it takes the irrevocable plunge of electing LIFO. But this *caveat* should not be misconstrued. For example, even in so volatile a field as plastics, we are not saying, nor would we agree, that LIFO offers no prospect of net advantage profit-wise for a manufacturer or a manufacturer-user of these chemical compounds. We say only that firms in such circumstances should scrutinize closely the technical position of each item of their inventories before electing LIFO, lest they forfeit thereby FIFO's advantages in spreading out the risk of inventory losses on discontinued items *without gaining an advantage that more than offsets it.*

In conclusion, it will be evident that we have reached no neat and definite verdict on the profitability, in general, of a firm's election, now or hereafter, to use the LIFO method. I can sum up the gist of this paper in a sentence: Weighing LIFO on the economic scales is a process that well repays the effort when applied to concrete business situations but leads to no generalized judgment on the merits of this method of inventorying.

AN ADIRONDACK VIEW

Your Accounting Library. Is it complete? Is it arranged so you can find something you want in less than an hour? How many volumes are missing because they have been borrowed and never returned? Does it line your office walls in order to give the proper intellectual atmosphere?

And does it contain Preston's TREATISE ON BOOKKEEPING? Probably not, so here is a partial review of the book.

Single entry, in three different plans, is explained. Notes payable include those payable in property like sheep, swine, wheat, corn and rye. Are you up-to-date on these things? Many kinds of legal forms are given—bonds, leases, deeds, wills.

Double entry gets covered with five sets of books. And the book closes with many pages on the subject of Equation of Payments and mentions that tables of interest at 7, 8, 10 and 12 per cent are available. Now your interest needs are well cared for—you simply use the 12% table and divide by 4, 6 or 12 to get interest at the current rates of 3, 2 or 1%!

Ledger is spelled leger; that's a help! It's a 16⅔% reduction in work.

To get a copy of this book, you need to get going at once. Our copy is the 41st edition, dated July 1, 1853. Copies are obtainable at Rummage Sales at 10¢ per copy and up. Perhaps you'd better just refer to it at the Institute's Library—if they don't have a copy, they can have ours—we don't do much single entry work and we seldom equate payments, but of course it's different in the big cities!

LEONARD HOUGHTON, CPA
Of the Adirondack "Chapter"

Techniques of LIFO Record-Keeping

By Joseph A. Dowling

This paper presents the principles and methods for using LIFO in the inventory accounts, after pointing out the added complexities in the problem due to income tax considerations. The mechanics of the unit method of inventory control as well as those of the subdivisions of the group method known as quantitative control, dollar control, and dollar value pool control are discussed. Finally, the effect of LIFO upon the cost accounting process is considered.

This discussion is devoted to an examination of the principles and methods for using LIFO in the inventory accounts. Our objective is to deal with the "how to do it" aspects rather than the "should we do it" aspect.

The Basic LIFO Concept

At the outset, it is desirable, in the interests of clear presentation, to refer briefly to the fundamental idea of LIFO and to the terminology associated with it, even though in doing so we take some risk of boring you with the elementary. The fundamental concept of LIFO is that a business immobilizes a part of its capital in keeping on hand the quantity of stock required to operate the business, and that a realistic accounting records that necessary quantity of stock at the prices first paid for the stock. It's pretty much the same as investing a part of the company's capital in a building—the original price paid for that building remains unchanged in the accounts throughout the life of the building and that might well be the life of the business also.

Joseph A. Dowling, is Chief, Classification Section, Accounting, at the Johns-Manville Corporation. He is an associate member of our Society and a member of the N.A.C.A. Mr. Dowling holds the degree of Master of Commercial Science from New York University.
Mr. Dowling is a member of our Committee on Cost Accounting and Inventory Methods and of our Committee on Publications.

This paper was presented by Mr. Dowling at a technical session of the 18th Annual Conference of the Society, held at Saranac Inn, New York, on June 26, 1951.

The quantity of stock on hand when LIFO is first adopted is the base quantity; the cost of that stock is the base cost. Increments are increases in the base quantity of stock, and the replacement reserve is a provision for paying more than the base cost when a temporary depletion of inventory is replaced in some subsequent period; current prices are those paid in any given year and may be the first prices paid during that year, the last price of the year, or the average price of the year.

When, at the end of the first year of operation under LIFO, the inventory quantity is the same as the base quantity, the value of the beginning inventory and the value of the ending inventory will be identical; if the quantity of inventory increased, the base quantity is valued at base prices and the increment is valued at current prices; if the quantity has decreased, a reserve for replacement is set up for the difference between the base cost value and the current cost value of the quantity of decrease. In the succeeding years, essentially the same general procedure is employed but complexities will arise —when quantities increase in two successive years, there develops different layers of increments; when increase

follows decrease the reserve for replacement is used to absorb differences between base cost and current cost to the extent of making up quantities previously depleted; when decrease follows increase the top layer of increment of the preceding year is first removed, then the next underlying layer, down to the base cost of the base quantity. When in any year the prevailing market price is less than the costs used in valuation of the inventory, an adjustment to the "lower of cost or market" becomes necessary.

Complexities Caused by Tax Considerations

LIFO can be and often is a very complex procedure to administer, particularly by reason of the fact that its operation cannot usually be based purely on accounting considerations. It would be academically ideal if accountants in dealing with accounting problems could devote themselves wholly to appraising and reporting economic phenomena according to appropriate accounting principle, without reference to the incidence of income tax regulations. However, in LIFO it is notably true that an accounting method which does not respect income tax regulations will not give the minimum income tax liability. No client, no employer would want the accountant or the accounting systems which failed to recognize and give precedence to income tax consequences, so it is that the accountant in working with LIFO must first find out "what the regulations permit" and then within the limits of that area devise the accounting procedure. LIFO is a tandem bicycle with the accountant in the rear seat and the tax law writer in front doing the steering. Consider how this development can give bad accounting but presumably good tax planning: make a cursory review of recent annual reports, quickly it will be demonstrated that it is commonplace to have some inventories on LIFO and some on FIFO—surely within the same company, one or the other, not both, gives the correct accounting result. Furthermore, some companies will divide finished goods inventory into its components of raw materials, labor and overhead, then use LIFO for the raw material component and FIFO for the labor and overhead. Let me give another illustration or two of situations wherein the work of the accountant is made more complex by the influence of tax law: When the accountant comes to work out the group or pool arrangement of inventory under LIFO he must think not so much about what is logical and relevant to the business operations but rather what pooling or grouping will be acceptable to the revenue agent who examines the tax return based on such accounting. And, one other point about this aspect of the subject: generally speaking an accountant is not responsible for the level of inventory quantity, yet with LIFO and the tax consequences of "losing base" he would probably be considered derelict in his duty if he, the accountant, did not point out the benefits of buying more goods before year-end in a situation where inventory was declining in a period of rising prices. I have heard it said in one company that the purchasing department makes no important purchases toward year-end without consulting the company's accountants about the current LIFO position and the effect on that position of buying, or not buying, at that particular time. It seems that LIFO has many facets: it exerts pressure not only to make an accountant a tax man but also a kind of novice economist.

I should have preferred to discuss the operational part of LIFO without any reference to income tax, but have found it unavoidable to make this incidental commentary in order to show reasons for the added complexity of LIFO as an accounting procedure, and to give some background for talking about the different methods of LIFO application which follow.

Application of the LIFO Principle to Inventory Accounts

In the application of LIFO principle to the inventory accounts, the choice lies initially between a unit method, that is, dealing with individual items of inventory separately, and a group method, which is combining items of inventory into groups. The group method can be subdivided into what I will call quantitative control and dollar control. Subdividing still further the dollar control can be achieved through the use of general indices as used by department stores under the retail method of account, or by the use of what has come to be known as the dollar value pool.

The Unit Method

The unit method is that of applying the test of last-in-first-out to each individual item of inventory. If there are a hundred items in stock, the quantity and price of each of the hundred items must be separately considered in respect of the opening and the closing inventory. The clerical work attached to the individual unit method is very great when the number of items of inventory is large, so much so that when the business has many thousands of items, as in a department store or in any business having a great variety of products, the method is impractical to use. I know of one large company which uses it, but keeps it within practical limits by using LIFO for only a limited part of its total inventory—the items which represent large amounts of money, and where it is possible to have a worth-while percentage of dollars covered by a relatively small percentage of the number of items in inventory. The unit method is therefore an expensive one to use in respect of the clerical effort required to be expended. It has another serious disadvantage in any business where there is a changing and shifting of the products sold. If one product is discontinued and a new one substituted, the new product takes not the cost of a base period, but the current price of that product at the time it is added to the line, and the base cost (presumed to be a lower cost item in times of inflationary spirals) is lost. It can be seen that in any business where there is an evolution of product change, the over-all effect over a period of years would be to drop most of the original base costs from inventory and substitute higher costs (again on the assumption that there is through the years a rising price level). This action is not only an income tax disadvantage but also a departure from the fundamental concept of LIFO—the concept of immobilizing that part of the original capital of the business which is dedicated to investment in inventory. It is the narrowest kind of grouping, and therefore the least desirable for income tax use. The unit method then is expensive to operate, departs from the basic idea of LIFO, and isn't the best for income tax determination.

The Group Method—Quantitive Control

Under the group method, which we will now review, I have referred to one subdivision as the quantitative control —keeping LIFO control through quantity group of homogeneous materials. When the principal products of a business consist of a single or a few basic raw materials, such as lead in a lead company, or cotton in a textile company, the quantitative group method is used. At one time it was thought that LIFO was suited only to companies of this kind. In the operation of this method the materials, being homogeneous, are easily converted to a common unit—tons of lead, pounds of cotton. Obviously the clerical problem is not a burdensome one—so many tons of lead or pounds of cotton at an easily computed price. Where there are different grades of the same basic material, it is possible to find a weighted average price for application to the total quantity of the material. In point of income tax advantage it is a broad grouping, and as we have indicated previously, the broad groupings are pre-

ferred over narrow groupings when the objective is the maximum income tax advantage.

The Group Method—Dollar Control

Still in the group methods, we now turn from quantitative control to dollar control. The underlying thought of the dollar control method adheres closely to the basic concept of LIFO—immobilizing a given volume of dollars in inventory. This idea of dollar calculation first came into prominence when department stores used price level indices to reduce the value of their inventories from current prices to base prices. It is probably the only practical method of using LIFO in department stores, variety chains and others having thousands of items, with a high percentage of items having small unit value. Inventories are usually grouped by departments and indices applied to departmental totals. This index method (acceptable for income tax use since the *Hutzler Bros.* case) has the advantages of rather broad grouping, of meeting the essential objectives of LIFO, and of causing no considerable amount of clerical detail.

The Group Method — Dollar Value Pool Control

The last method which we will discuss in any detail is the dollar value pool control. It is very much like the index method of department stores in some respects—it can be used for businesses having a wide variety of items in inventory and, in part, depends upon an index. The mechanics of the dollar value pool control were well described in the February, 1951, issue of the Journal of Accountancy. To review it in outline form, its operation requires a list of quantities by items for the beginning of a year and a similar list of quantities on hand at the end of the year; also required is a list of base costs for these items, and a list of current costs for the same items (for our illustration we will regard the current costs as those prevailing at the end of the year). The beginning and ending inventories are both valued at base costs; since the same costs are used for both inventories, the change or difference between the two dates must be the increase or decrease in quantity. So, step No. 1 finds quantity difference. Then, the ending inventory is valued twice—once at base cost and once at current cost; the difference between these two, expressed as a percentage, gives the index of price change. If the quantity test shows an increase in quantity, the amount of this increase is multiplied by the index of price change found in step No. 2, and that gives the value of the increment. The value of the beginning inventory plus the increment computed as just described, gives the value of the ending inventory. It will be noted that this procedure is in its nature the same as that used in the individual or unit method with the important difference that a large group is valued at one time rather than a single item, and individual items of decrease tend to offset the individual items which have increased. If accounting needs were the only ones to be covered, it might be enough to deal with the entire inventory of a business as being just one group, and this would give the maximum possibility for matching decreases against increases. However, the influence of income tax regulations enters and it is required to divide the business into groups or pools of inventory. In one case passed on by the courts, the *Basse* case, the warehouse inventory of a wholesaler grocery company was classified into 27 pools (groups). Groups are usually formed according to the similarity of product, or similarity of manufacturing process, or other basis of common relationship. They should be as broad as circumstances permit.

Dollar pool is adaptable to any kind of business. Clerical details are not difficult to master nor perform, so the clerical cost is moderate. You will perhaps remember that it was stated previously that each item in inventory must have a unit cost—a base cost and a current cost. When a new item is

added to a group, there will be the question of a base price—is it the price of the first purchase made of that new item, or is it the cost that would have been paid if the item had been bought in the base period. The principle of maintaining a given level of inventory dollars of freezing a certain dollar amount of inventory, dictates that the new items should come into the inventory at a base cost constructed to represent the price which would have been paid if the item had been in stock at the base period. This idea may present some computation problems for the cost accountant—finding what the cost of a product made this year for the first time would have cost several years ago when the LIFO method was started, but unless it is done, the result would otherwise be a gradual upward revaluation of the inventory in any company where there is a history of new product development to supplant obsolescent products.

Effect of Technological Improvement Upon LIFO

An interesting question can arise in connection with the base cost of an item subject to technological improvement. Consider the radio industry. 25 years ago an inexpensive radio cost about $200; today an inexpensive radio costs about $25. Suppose a radio company were on LIFO 25 years ago—what is the base cost of an inexpensive radio in stock now. In the opinion of some students of the LIFO method the base cost of today's set is not the $200 of 25 years ago, but the quotient of $25 divided by the index of 1926 price (25 years ago) with 1951 prices. This would conform to the objective of keeping price level increases out of inventory values; to do otherwise would create the undesirable effect of financially immobilizing the technological status of the time when LIFO is first adopted.

Other LIFO Methods

There are other methods closely related to LIFO and conceived to achieve the same objectives,—these are the normal stock method which was really the forerunner of LIFO, and the inventory reserve method. However, we will not devote any time to them, because strictly speaking they are not LIFO methods and are not acceptable for income tax purposes, hence not likely to be adopted in the future.

Effect of LIFO Upon Cost Accounting

These, then, are the several methods by which a valuation of inventory is established. Let us now turn to the other side of the accounting equation—that equation which says that disbursements plus or minus inventory changes gives cost of goods sold. Let us ask ourselves what is the incidence of LIFO upon cost accounting. We will use the term cost accounting in its very broadest meaning: that of being any analysis of cost, whether by product, by department, by territory of other useful cross-section of cost. Should LIFO be integrated into cost accounting, or should it be superimposed on the costs developed through cost accounting. From the inquiries which I have made in several companies which use LIFO and have cost systems, I learn that the most common practice is to superimpose the LIFO adjustments: that is, do the cost accounting necessary to find the unit cost of goods manufactured or sold without reference to LIFO and then add to or subtract from the cost of sales the adjustment necessary to express inventory values on a LIFO basis. One large company did tell me that they tried integrating the LIFO method into their cost accounting but found the results so very unsatisfactory to the operating executives of their plants that it was abandoned in cost reports. An important complaint of the operating men was that the seasonal rise and fall of inventory caused depletion of base quantities in some months and build-up of inventory in other months; in months of depleting raw materials the

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Has LIFO Raised or Solved Accounting Problems?

By Gregory M. Boni, C.P.A.

The considerations which would enter into the long-time outlook of a professional accountant in gauging whether or not accounts maintained on a LIFO basis ". . . present fairly the financial position . . . and the results of . . . operations . . ." are considered in this paper. Some very difficult questions of accounting theory inherent in the use of LIFO accounting are raised and neatly discussed by the author.

The arguments for and against LIFO accounting are probably as active as any which are being carried on today about accounting subjects. FIFO accounting has been opposed not only by LIFO but also by HIFO (highest-in, first-out) and NIFO (next-in, first-out). Some of the participants in this discussion treat LIFO as a new school of accounting thought whereby many of the accounting problems inherent in historical cost can be solved. Others merely speak (sometimes with contempt) of LIFO as a tax-saving device. These latter disputants do not credit LIFO with any legitimate place in disclosing financial position or measuring income.

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The truth probably lies as a bridge across these opposing views: LIFO may be the prelude to a new concept of accounting which is being adopted by more and more large companies, but the reason for its adoption is largely because of its tax-saving possibilities rather than because of the accounting philosophy underlying its use.

In the book "Inventory Accounting and Policies" by J. K. Butters,[1] the following data are submitted concerning inventory bases used in 1947 reports of manufacturing companies:

Total Assets (in millions)	Using LIFO	Non-LIFO	Total	% of LIFO to total
0- 10	28	161	189	14.8
10- 50	78	168	246	31.7
50-100	29	34	63	46.0
100-500	37	29	66	56.1
500 and over..	11	4	15	73.3
	183	396	579	31.6

It is significant that the frequency of use of LIFO materially increases as the size of the company increases.

It is interesting to peruse the articles on LIFO which have been written dur-

[1] Harvard University Graduate School of Business Administration, Division of Research, 1949.

ing the last fifteen years. The early articles argued for the propriety of LIFO on the grounds that it represented a logical flow of costs. In recent years this argument is seldom mentioned, but the subject of LIFO has been brought together with the entire question of whether or not net income should be the excess of revenue over economic values parted with, or whether it should be excess of revenue over dollars parted with. Undoubtedly, the original proponents of LIFO did not contemplate that this method of accounting had such broad significance and would be part of the studies of a committee which is working on a definition of business income, for which the American Institute of Accountants and the Carnegie Foundation have contributed $100,000.

Even though LIFO probably is being adopted because of tax reasons, it nevertheless has highly significant financial accounting effects. Because of its increasing prevalence in financial statements, whether or not through the back door, it merits examination without regard to its tax benefits. Accordingly, I want to try to cover the considerations which would enter into the long-term outlook of a professional accountant in gauging whether or not accounts maintained on a LIFO basis "present fairly the financial position . . . and results of operations . . . ." The considerations involved are, of course, also applicable to a corporate officer endeavoring to consider whether he is fulfilling on a high plane his responsibility to account to stockholders. My remarks, therefore, relate to financial rather than managerial accounting. Because I have encountered confusion in the past, I wish to point out that I define financial accounting as the accounting to those who have a present or prospective interest in a company, but who are neither inclined nor in a position to obtain an understanding of the accounts through intimate knowledge of the actual operations of the company.

Effect on the Balance Sheet

The inventory balance on a LIFO basis, which appears in the balance sheet, cannot be classified as a very useful figure. It is true that many accountants now consider the entire balance sheet a statement which is not very meaningful. However, at least one class of persons, that is, credit men, continue to consider the balance sheet an important document. The use of LIFO accounting has made the balance sheet less useful for this purpose. Things would be bad enough in this respect without the confusion generated by inventories being partially on a LIFO basis and partially on some other basis. Even when inventories are entirely on a LIFO basis, very different results may be attained if one method of applying LIFO is used as contrasted with another method. The dollar-value method, about which you have heard from the previous speaker, might result in entirely different inventory amounts than would be the case if the specific quantity-matching method were used. Following this thought, in the dollar-value method depending upon the groupings of commodities, widely varying inventory amounts may be obtained. Further differences among inventories may result from the fact that there are three methods by which increases over the beginning-of-the-year inventory may be valued.

There is not much question but that LIFO accounting has further contributed to the truth of the statement that a balance sheet consists of "non-homogeneous residuals." While at one time we basically had two classes of residuals, that is, reasonably current dollars for current assets, and historical dollars for non-current assets, since LIFO we also have historical dollars for one of the important current assets. To add to the confusion, the historical dollars applying to the latter item were incurred in connection with an asset which is not physically on hand, and the age of the dollars used will vary with the method used. Is it a paradox that in

endeavoring to charge current-value dollars against operations, accountants have moved one more item on the balance sheet back to historical dollars?

Admittedly, LIFO accounting is concerned with improving the reflection of operating results rather than in the effect which it has upon the balance sheet. In more than one respect this object is achieved. LIFO is an admirable solution of an important problem. However, in appraising the validity of this contention, it must also be admitted that the introduction of LIFO has injected a factor which tends to place the statement of operations in a class with the balance sheet, that is, the statement of operations is no longer homogeneous. LIFO has introduced a factor into the statement of operations which tends to compensate for the change in the value of the dollar. This has not been done for other charges made to operations, notably, charges for depreciation.

Effect on Short-term Operating Statements

In passing, I wish also to recall that LIFO accounting is difficult to apply to short-term operating statements needed by management. Because of interim reductions of inventory below beginning inventory balances, various estimates must be made as to the status which will obtain at the end of the accounting period in order to be able properly to establish reserves for replacement.

There is no dispute as to the fact that LIFO accounting may produce results which are significantly different from other methods of accounting. This, aside from its accounting significance, may have serious practical implications. For example, how will participants in a profit-sharing plan react to the change from FIFO to LIFO? What would be the position of a company which has a bond indenture requiring that a certain ratio be maintained of current assets to current liabilities? It might be also pleasant to think of the fact that carrying inventories on a LIFO basis often has the effect of reducing personal property taxes.

Status of LIFO Today

In the light of all of the foregoing effects of LIFO upon accounting, few of which can be claimed to be immaterial, where do we stand today and what forces are in action which may change the present status? LIFO accounting is considered to be a choice of method which is available to management, and is recognized as an accepted basis of accounting under Bulletin 29 of the American Institute of Accountants. It is, nevertheless, considered essential that disclosure be made in the financial statements that the inventory is on the LIFO basis. With this disclosure, no comment is required by the independent accountant in his report. Of course, the opinion must disclose the effect of the change in the year in which a change is made from FIFO to LIFO. In the event of a published table of earnings covering some years which were on a FIFO basis and others on a LIFO basis, it is usually necessary to disclose information which would make the respective years comparable.

Forces of Change in Action

At the present time there are those who are endeavoring to make slight changes in practice and there are others whose point of view, if adopted, would completely change the present practice. First, there are those who feel that the replacement values should be reflected parenthetically when inventories are on a LIFO basis. The adherents of this viewpoint to the lack of comparability between companies in the same industry whose statements are prepared under two different bases of inventory valuation. It is also pointed out that the reasonable assumption to make when inventories are on a LIFO basis is that a sizeable cushion exists. It

might be true, however, that only a small or no cushion exists and, without disclosure of replacement costs, the statements would thus be misleading.

Opponents of disclosure of replacement costs argue that to do so invalidates the method of accounting adopted by the management. They further argue that, rather than contributing to increased significance of statements by such disclosure, the opposite is true. Inventories on a LIFO basis, they say, are similar to a fixed asset in that they are not to be disposed of, and any implication that a profit can be realized on the difference between the carrying value and the replacement value is erroneous. The other complication in this respect is that, even if profit were to be realized, let us say on ultimate liquidation of the company, the amount available to stockholders would be only net of taxes. Opponents of disclosure also argue that there is no reason to single out inventories for disclosure of replacement values. If, in general, replacement values are significant, such amounts should be required for other assets as well.

One school of thought very strongly and logically argues that financial statements of all companies should be on a LIFO basis. Unless the entire fundamental question of the nature of business income is resolved in this direction, I do not believe that all companies will adopt LIFO.

Carrying the disclosure of replacement costs one step further, it has been suggested that inventories be carried at replacement costs, and the difference between replacement costs and the LIFO amount be reflected in the stockholders' investment section of the balance sheet. Presumably, the caption of such an item would be something like "additional stockholders' capital invested in inventory." This suggestion is interesting and has much merit. However, it would first be necessary to determine the very practical question of whether this method of presentation would meet the requirements with respect to LIFO of the tax law as to maintaining one's reports on the basis used for filing tax returns. Aside from this question, however, there is, once again, the old bogy that giving one-half a loaf may be misleading in that the reader could be led to believe that he had the entire loaf. This suggested method of disclosure implies that the stockholders' investment section has been adjusted to reflect increased requirements for permanent capital. In view of the fact that for most companies a large portion of the surplus has been reinvested as permanent capital and is not available for dividends, it would appear that that problem would also need to be coped with before it would be advisable to adopt the suggested method of handling LIFO in the balance sheet.

Moving along to the more-thoroughgoing suggestions, it has been recommended that all the elements of the operating statement, which adjust for changes in the value of the dollar, be removed, and that the operating statement be presented entirely on the basis of historical costs. Then, in an adjoining column the operating statement could be presented entirely on the basis of the economic value of the consideration which has been given up in order to earn the revenue for the period. This presentation has the decided advantage of giving information from which the reader may make his own adjustments, and also gives, without distortion, one kind of adjustment which may be made to the results for the period. While this may be a solution which will come about, one hesitates to adopt it because it seems to be an acknowledgment that we cannot cope with the problem of deciding upon a single significant figure to be called net income which would be most useful for all purposes. Psychologically, we always strive for a neat solution, even if it is not possible.

Strong forces are in operation to move in exactly the opposite direction of this last proposal. Many accountants, economists, and others advocate that the entire operating statement should be based on matching of costs

expressed in current dollars with revenues which, by their nature, are also in current dollars. This would, of course, mean primarily that charges for depreciation would be adjusted to reflect a consumption of assets valued on a current-dollar basis. This would thus eliminate questions about the operating statement being non-homogeneous. The arguments for determining net income in this manner have in the view of many almost incontrovertible theoretical merit. It is only in the practical applications of this procedure that one runs into the as-yet-undecided question of whether in the long run statements prepared on this basis would be more useful and meaningful than those prepared on some other basis. It is questionable, for example, whether in the long run statements prepared on this basis would come closer to reflecting the year-by-year progress of the company than is the case when historical costs are used.

Conclusion

After considering the difficulties inherent in the use of LIFO and the forces in operation which are attempting either to amplify, change, or extend LIFO, it is inevitable that the conclusion must be reached that LIFO is a step in the ever-evolving pattern of accounting methods. It is highly useful in pointing up the questions involved in arriving at net income. As a result of its use, we have been made conscious of problems which need to be solved and possibly have gained a clue as to how they may be solved. It is extremely doubtful that LIFO could withstand, without change, the forces which are endeavoring to move it.

Techniques of LIFO Record-Keeping

(Continued from page 743)

manufacturing costs were unnaturally low and the converse became true in the months when depleted inventories were replenished. This same company told me that it took three years to untangle the cost accounting details after they decided to give up the integration of LIFO with cost accounting. Now, there is something like a middle course between integrating LIFO and superimposing it, and that is detaching cost accounting from the general accounting. I have observed this in practice and so far as can now be known it is working out satisfactorily. Under this so-called middle course, the cost of manufacturing a product is computed from the latest raw material prices, without reference to the fact that a different cost might be obtained from the inventory of raw materials on hand. Likewise, as goods are shipped out to the customers, the individual sale is costed with the latest manufacturing cost for the purpose of finding gross profit by products, without reference to the fact that the average unit cost of the finished goods on hand may be different by a wide margin. The result is to have in the cost of sales details always the latest costs. Obviously the equation is thrown out of balance by such method because the charge to cost of sales will not be the same as the amount required to be credited to inventory to maintain it on a LIFO basis. The correcting factor is an over-all adjustment to the total cost of sales.

Conclusion

In the early part of this paper I mentioned that LIFO is a complex procedure to adminster, and now as we reach conclusion of the topic I think I can safely repeat that thought—LIFO is complex, particularly in its incidence on the myriad of details found in any large company. Hope for simplification of it in the future lies in the possibilities of greater use of LIFO by more companies, which will bring more accounting minds to concentrated study of it.

Technical Tax Aspects of LIFO

By F. M. Budik, C.P.A.

Certain technical income tax aspects of LIFO accounting are discussed herein: the election to use the LIFO method; various acceptable methods of LIFO accounting; changing to the LIFO method; involuntary liquidations and subsequent replacements; claims for refund; and deficiencies resulting in additional assessments.

Election to Use LIFO Method

Any taxpayer using inventories in the determination of taxable income may elect to use the LIFO method. It may be applied in inventorying any of the raw materials, work in process, and finished goods. As in the case of other inventory methods, such as the lower of cost or market, LIFO may not be applied to such items as supplies, used in the process of manufacture or for repairs or maintenance, which do not physically enter into the product to be sold. In lieu of electing to price raw materials, work in process, and finished goods on the LIFO method as separate classes, the taxpayer may elect to apply LIFO to the aggregate of the raw material and the raw material content of the work in process and finished goods. This alternative is available to taxpayers making the election for the first time, as well as to those who previously elected LIFO separately for one or all of the three classes. In the latter case, a change to LIFO for raw materials and raw material content basis may be made by informing the Commissioner of such change, which will be effective for all open years to which the original LIFO election applies and for all subsequent years, unless permission to change is granted by the Commissioner. The Regulations specify that under this alternative the election is limited to raw materials and raw material content. The Commissioner contends that this election precludes the application of LIFO to labor and overhead as a separate class of inventory. In cases where a taxpayer elects LIFO with respect to one or several, but not all classes of inventory, the Commissioner may require the application of LIFO to goods with respect to which the taxpayer made no election, if in the opinion of the Commissioner such application is necessary to reflect income clearly.

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LIFO Tax Accounting

LIFO may be computed by use of (a) the quantity method, (b) price indices, (c) dollar value method, and (d) any other method adaptable for the purpose and intent of LIFO. Whatever method is used, the result should be the elimination of the price changes that occur during the year and would be reflected in the closing inventory if a method other than LIFO were used in pricing the inventory. Increases in inventory not attributable to price changes must be added at current cost. For this purpose the taxpayer must use costs for the year of increase, determined by reference to the earliest, latest, or average costs, either for the full year or a shorter period. The method

of pricing increases must be set forth in the application referred to below, and must be followed consistently. The periodic annual additions are accounted for separately and are not merged or averaged with the preceding additions or with the inventory on hand at the time LIFO is first adopted. This procedure is necessary because liquidations that may occur during a year are deemed to be those goods most recently acquired, thus leaving in the closing inventory for the year of liquidation goods valued at the price level prevailing at the time LIFO was adopted, to the extent that such goods were not subsequently liquidated; and periodic annual additions are valued at price levels prevailing at the time the additions were made (in accordance with the method adopted for pricing additions), likewise to the extent that such additions were not previously liquidated.

Change to LIFO Method

The change to LIFO is made by filing an application on a form provided for that purpose. The application is filed with the tax return for the year in which LIFO is adopted, and must specify the goods as to which LIFO is to be applied. By signing the form the taxpayer agrees to permit the adjustment of prior years' taxes resulting from the statement of the opening inventory at market rather than cost. The opening inventory for LIFO purposes must be at cost, and any write-down to market at the close of previous year may result in a deficiency in the tax liability for prior years. As a condition to the use of LIFO for tax purposes, the company must also use LIFO in ascertaining income for credit purposes and for reports to shareholders, etc., for the year in which LIFO is adopted and for subsequent taxable years, except that market value in lieu of cost may be used for book and report purposes, when market is below cost. No write-down to market is permitted for tax purposes.

Once LIFO is adopted, it must be adhered to unless permission to change to another method is previously granted by the Commissioner.

Involuntary Liquidations and Subsequent Replacements

In cases where there are involuntary liquidations of inventory during the years ending after June 30, 1950, and before January 1, 1954, taxpayers may elect for any year to have the income and tax for the year of liquidation adjusted by the difference in cost of replacement and liquidation. Similar provisions were in effect for taxable years beginning after December 31, 1940, and prior to January 1, 1948. The election, which is irrevocable, must be made within six months after the return for the year of liquidation is filed, unless an extension of time is obtained in which to make the election. The taxpayer may have the burden of satisfying the Commissioner that the liquidation was involuntary as defined in the Code and the Regulations.

The earliest increase in inventories after a year of involuntary liquidation shall be deemed to be a replacement of the most recent liquidation, not previously replaced, whether or not such liquidation was involuntary. To the extent that the increase is identified with voluntary liquidations, no adjustment is made; but to the extent that the increase is identified with involuntary liquidations, such increase is included in purchase and inventory at the cost of the goods replaced, and the difference between such cost and cost of acquisition is applied as an adjustment to the year of liquidation. Under present provisions of the Code, replacements must be made for the purpose of the adjustment during years ending prior to January 1, 1956, with respect to liquidations in years ending after June 30, 1950, and before January 1, 1954. Replacements of liquidations in years beginning after December 31, 1940, and prior to January 1, 1948,

(Continued on page 782)

Accounting for Theatrical Productions

By WILLIAM BARNETT

The "angels" of a theatrical production are the investors therein whose money often has wings. This paper presents a system of good financial housekeeping in show business. Basic accounting and auditing procedures are discussed.

"There's no business like show business" and that applies to the financial affairs of a show as well as to the more glamorous aspects of an actor's life which are pointed out musically by Irving Berlin. The only difference is that the accountant can not emote, but must try to keep system in a field where good financial housekeeping is not regarded as a very serious subject.

To understand accounting for a theatrical production, it is best to start at the beginning after a producer has bought the rights to a play or musical and has aroused enthusiasm among individuals with money and the gambling fever, so that they are willing to invest in the production of the show. These individuals are sometimes called "angels" because their money has wings.

Limited Partnership Usual

The producer and the backers generally form a limited partnership for the production of the show. This means that the liability of the backers is limited to their investment in the partnership or to a certain percentage above such investment (termed a "call") and the producer (who is the general partner) is responsible for all liabilties and obligations in excess of the amount of the limited partners' liability. The backers receive 50% of the net profits of the show, divided in the proportion of each backer's contribution to the total limited capital of the partnership; the other 50% goes to the producer. Net profits in a theatrical production represent the amount of income remaining after all costs of putting on the show have been recovered. In accounting parlance, this means that all pre-production costs and expenses, and expenditures for scenery, costumes, equipment, and other production costs incurred before the show has its formal opening, are amortized against the first income received. This principle of rapid amortization is well established in the theatrical field and is based on the fact that the life of a show is uncertain. Losses suffered up to the aggregate contributions from limited partners are borne entirely by the limited partners in proportion to their respective contributions.

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During World War II he worked for the Treasury Department in Washington, D. C., as a civilian and then served in the armed forces as a sergeant in the Adjutant General's Office, European Theatre Headquarters, London, England.

His accounting experience in the theatrical field has been extensive and diversified.

Basic Accounting Procedures

Moneys received from backers are credited to a capital account called Investment of Backers. When the total capital of the partnership has been raised, the scenery, costumes, equipment and all the other items necessary to the production of the show are purchased, bonds are deposited with the various theatrical associations and unions, guarantying fulfillment by the partnership of its contracts with the cast and crew, and rehearsals are commenced. All of these costs and expenses (except the bond deposits) are charged to an account called Produc-

tion Costs and are classified by the type of expense or cost incurred. After a preliminary period of rehearsals (usually about five weeks), most well-financed shows "try-out" in cities reasonably adjacent to New York. The results of this try-out period are reflected in two separate accounts on the books: Box-Office Receipts—Try-Out, to which the company's share of the box office receipts is credited, and Running Costs—Try-Out to which the various expenses incurred; classified according to the type of expense involved, are charged. During this try-out period changes may be made in the show necessitating new scenery, costumes, music, etc., which are charged to the Production Costs account.

The total production costs and try-out losses represent the amount invested in the production which must be recovered from subsequent income before any net profit can be realized. It should be noted here that although bonds deposited by the partnership with the theatrical associations and unions are considered part of production costs in the limited partnership agreements and for budgetary purposes, such deposits are segregated from production costs by the accountant, as the amount is recoverable upon the closing of the show if the partnership has fulfilled its contractual requirements with the cast, crew and other employees.

The show is now ready to open on Broadway. All expenses starting with the date of the formal opening are carried in an account called New York Running Costs and box office income* is credited to an account entitled Box Office Receipts-New York Run. The New York Running Costs account is columnarized for the different items of expense incurred to keep the show operating such as salaries, departmental expenses (wardrobe, props, electrical and carpentry and rentals), advertising, transportation, auditing, etc.

Weekly Settlement Procedure

Settlements are made weekly (usually Saturday night) with the theatre ("house") in which the show ("company") is playing. The usual arrangement is for the theatre operator to have his own box office personnel collect the admission price and pay the excise tax directly to the government, even though the theatre gets the smaller portion of the admission price. After every performance the company manager and the box office treasurer tally the unsold tickets and agree upon the box office receipts, each signing the box office statement. The net amount due the company each week is arrived at by deducting from the company's share of the gross box office receipts all disbursements paid out by the house which are chargeable to the company.

One of the primary duties of the auditor is to see that the settlement was carried out in accordance with the provisions contained in the contract between the production and the theatre. Some of the provisions of the contract to which the auditor must pay particular attention are as follows:

(a) Division of gross box office receipts—usually 70% or 75% to company and 30% or 25% to house.

(b) Stagehands necessary to move show into and out of theatre ("taking-in" and "taking-out"). House usually furnishes a stated number of stagehands and shares with the company the cost of all additional help on the basis set forth in (a) above.

(c) Electrical operators "to work show"—usually paid for by company.

(d) Musicians (if a musical)—house usually pays for the first eight or ten and shares with the company the cost of the next ten, if used, on the basis set forth above.

(e) Advertising—all advertising (or the first $1,000) mutually agreed upon is usually shared between the parties on the basis set forth above.

Most contracts between company and theatre differ in some respects, but the foregoing provisions represent the cus-

* Represents the company's share of the box office receipts from the sale of tickets for performances in that particular week, regardless of when the tickets were sold.

tomary sharing arrangement. The auditor should also check the daily box office statements and, where possible, a reconciliation should be made between the sold seats, unsold seats, and total theatre capacity.

Other Income

Although the box office income is the major source of the partnership's income, if the show is a hit or if it runs for a reasonable length of time, other income will be received from souvenir programs, recording and sheet music royalties, sale of commercial rights, sale of rights to produce the show in foreign countries, sale of television and summer stock rights, etc. These receipts are posted to an account called Miscellaneous Income with columns provided for the various sources thereof. Certain other expenses which can be applied against this miscellaneous income are posted either as a debit to the Miscellaneous Income account or to another columnarized account called Expenses Chargeable to Miscellaneous Income (or some other similarly named account). The latter treatment is preferable in order to facilitate determination of the gross other income for gross receipts tax and report purposes.

The weekly net operating income is computed by deducting the weekly running costs from the company share of the box office receipts. To this amount is added the net miscellaneous income received during the week, and the resulting figure represents the net profit for the week. The net profit on the whole production is the excess of the sum of the net operating income and net miscellaneous income over the production costs and try-out losses.

Weekly Accounting Basis

Since the settlement with the theatre is made weekly, the books of account are also kept on a weekly basis. The cash books are closed each week and postings to the general ledger are also made weekly, to facilitate compilation of data for financial reports. Bank accounts are reconciled as of the last Saturday of each month. Generally, theatre accounts are kept on a cash basis. However, the weekly reports would be distorted unless items such as insurance and transportation charges (where show is on the road) are pro-rated with the applicable portion charged to the appropriate week. Also, some bills are paid monthly and the accountant must use his judgment in pro-rating these expenditures over the weekly periods covered by the monthly bills.

Auditing Pointers

From an auditing standpoint, there are several contracts that need review and follow-through. The contract between the producer (general partner) and the backers (limited partners) is called the limited partnership agreement and it is the auditor's duty to see that the provisions of this agreement are being carried out. The usual limited partnership agreement specifically provides that the net operating income is to be applied first, to the payment of any obligations of the company and, next, to the return to the limited partners of their investment in the production. After the investors have had returned to them all of the capital which they invested, the remaining and future profits earned by the production are divided 50% to the investors, in proportion to their respective individual investments, and 50% to the producer. It is the auditor's duty to see that the profits are distributed in exactly this manner. Some of the other items which the auditor must check are as follows:

(a) See that the total production costs, including out-of-town try-out losses and security bonds do not exceed the estimated production costs as set forth in the limited partnership agreement.

(b) See that the weekly office charge (usually $250) paid to the producer is correct and that the payments commence and terminate at the proper dates.

(c) See that the proper sinking fund is being maintained before distributions are made to backers.

(d) See that any special arrangements made with authors, directors, chore-

ographers, etc., for payment of compensation, royalties, or out-of-town living expenses, agree with the amounts actually paid to them.

Another contract with which the auditor must concern himself is the Dramatic-Production contract (for a straight play) or the Dramatico-Musical Production contract (for a musical). This is the contract made between the author (or authors) and the producer wherein the following information can be obtained:

(a) Initial payments and advances to authors.
(b) Royalties payable to authors (on box office receipts, from sale of phonograph records, from sale of motion picture, television and foreign production rights, etc.)
(c) Other compensation — for preparing musical arrangements and orchestrations, travel expenses while on the road with the show, etc.

It is the auditor's duty to see that any disbursements made to the authors or their agents are in accordance with the provisions of this contract.

Other contracts to which the auditor must refer for authorization of disbursements or for verification of the correctness of income received are:

(a) Contracts with scenic designer, costume designer, choreographer, and director.
(b) Contracts for rental of props, electrical and sound equipment.
(c) Employment contracts with members of cast, stage manager, and stage crew.
(d) Contracts with music publishers and recording companies.

Financial Statements

The general partner (or partners) is required to deliver to the limited partners a monthly statement of operations, duly audited. Of course, this duty is delegated to the independent auditors. In this statement the results of the operations for the period are shown and, in addition, a financial summary for the complete run of the show to date is given, showing all profits (according to source), distributions made to partners, remaining assets and liabilities.

Other reports for which the auditor is usually responsible are:

(a) Not later than thirty days after the play opens in New York City—a complete statement of production expenses.
(b) In the event of the show closing and within thirty days thereafter—a detailed statement of the operation of the partnership and also a final liquidating statement.
(c) Federal and state income tax returns showing the income of the partnership and each partner's share thereof.

As is generally the case in a creative enterprise surcharged with emotion, record-keeping and internal control are likely to be relegated to a subordinate position. The auditor must insist upon the maintenance of adequate vouchers properly authorized. There is a tendency in the theatre, as in other such enterprises where a few managers are responsible for the interests of a large group of investors, to be somewhat free-spending. They feel that the net effect to each investor is insignificant. The backers have the right to expect that everyone acting in behalf of the production will exercise the same prudence as if each was handling his own money. The independent auditor must justify the faith placed in him by disclosing to the backers everything of financial significance and constantly encouraging the economical operation of the enterprise, although in many situations, the auditor will not be in a position to judge which expenditures are reasonable and necessary.

Financial stability and confidence could be enhanced in the industry if increased consciousness were given to adequate accounting. The Committee of Theatrical Producers is to be commended for having this on its agenda. In its effort to spread confidence among backers it has met with leading accountants in the theatrical field to discuss the possibility of formulating a uniform accounting procedure applicable to costs, operating expenses, and preparation of financial statements. In effect it is somewhat similar to Wall Street's SEC.

The "Funds" Statement Re-examined

By Robert H. Gregory, C.P.A.

This article contains a critical analysis of the views expressed in a previously published paper by another author. We hope that it will rekindle our readers' interest in this important subject.

Mr. Myer's article entitled "The 'Funds' Statement" in the May, 1951, issue of *The New York Certified Public Accountant* is extremely interesting. According to Mr. Myer, it seems that a whole array of "funds" statements can be prepared. Certainly the funds statement now converted to "funds" statement by Mr. Myer has become more valuable than the alchemist dared dream.

I would like to make several observations about points in Mr. Myer's article.

First, he says (on page 353) that ". . . Calling the statement a 'funds' statement has focused attention on the means rather than the end with the result that the statement is commonly regarded as a sort of reconciliation of the capital, working capital, or cash, as the case may be, at the end of a period with that at the beginning." It is difficult to see how the name "statement of funds" has focused attention on the means instead of the end any more than will the suggested title "funds" statement.

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Second, any statement that attempts to explain the changes that occur over a period of time must, by its nature, reconcile certain amounts. Otherwise it is an unsatisfactory explanation of the changes that occur. Each of Mr. Myer's "fund" statements (Exhibits II, III and IV) starts with the beginning balance and arrives at the ending balance so that each one completely reconciles the two balances. Some other writers used the same type of fund statement.[1] Generally, however, the suggested form of funds statement shows that the total amount of funds provided is equal to the total amount of funds applied. Mr. Myer's suggested form that shows both the beginning and ending balances is more clearly a reconciliation (although all forms explain all the changes that occur) but is, I think superior to the widely-used form that shows that the amount of funds provided is equal to the amount of funds applied.[2]

[1] For example, William J. Vatter in "A Direct Method for the Preparation of Fund Statements" *Journal of Accountancy*, 81:479-89 (June, 1946), shows a fund statement on pages 484-5 that traces the change in current residual equity (working capital) from the beginning to the ending balance. However, on page 489 Vatter shows a seldom used fund statement that has as a final amount the net increase in current residual equity. Myer used the same form in "Statement Accounting for the Balance Sheet Changes", *Accounting Review*, 19:31-8,3 (Jan., 1944).

[2] The forms of fund statement that show (1) the beginning and ending balances or (2) the net increase or decrease in funds both avoid the absurdity of calling an increase in working capital an application of funds (working capital). Myer pointed this out on page 38 of his article in the *Accounting Review*, January, 1944.

It would not be incorrect, I think, to observe that Mr. Myer's Exhibit II "funds" statement on the capital basis is a purely mechanical reconciliation of changes in account balances that focused attention on *means* and *reconciliation* of changes and has no end use whatever. A simple statement of the changes in comparative balance sheets would be far simpler and more useful than his "funds" statement on the capital basis.

Third, let us look at that part of Mr. Myer's statement quoted above which says that ". . . the statement is commonly regarded as a sort of reconciliation of the capital . . ." Few other writers (if any) regard a fund statement in this way. In fact, on page 32 of the article noted earlier in which Mr. Myer dealt with the history of the fund statement, he said "This statement[3] has been named by the writer the statement accounting for variation in net worth." It seems unusual that a commonly-used statement did not even have a name until Mr. Myer furnished one in 1944. The name ordinarily used for a reconciliation of the capital of a partnership goes by just the simple name "statement of partners' capital." The word "fund" is rarely, if ever, used in connection with either a statement of capital for a partnership or a corporation.

Without appearing to condone the use of a "funds" statement on the capital basis, I would like to discuss it a bit more. Exhibit III does not indicate (1) profits, (2) investments, or (3) withdrawals. Instead it tabulates all the changes in non-capital accounts and shows that the net amount of change is equal to the net change in partners' capital. This is mathematically correct; but it has no significance. It would be equally correct mathematically (and equally useless, I fear) to prepare a statement of the changes in any balance sheet account by tabulating the changes that occurred in all other accounts between two dates. Mr. Myer does not, of course, fall into his own trap but uses a different plan for preparing his "funds" statements on the working capital basis and the cash basis.

Fourth, a vital fact is missing in the illustrative problem. The facts concerning either the partners' investments or withdrawals are necessary in order to obtain the suggested solutions. As now stated it is impossible to deduce from the facts that (1) each partner invested $2,000 during the year and (2) each partner withdrew $5,225. The missing information about the furniture sold (cost $875, depreciation to date of sale $350) can, however, be logically deduced from the facts.

Fifth, the "funds" statement on the cash basis seems unnecessarily complex. In fact, on page 358 Mr. Myer points out that "The adjustments for the increases and decreases in the accounts receivable, accounts payable, and prepaid expenses tend to complicate the statement on the cash basis to such an extent that it is certainly less understandable than that on the working capital basis . . ." The question naturally arises whether the mixture of the accrual and cash basis results in a "funds" statement for cash on the cash basis. The use of the accrual basis for income recognition in this case hopelessly confused the problem of preparing a statement describing the change in the cash balance. This contention is borne out by Mr. Myer's further comment on page 358 that "The statement on the cash basis shows the cost of the goods purchased for resale since cash is decreased by the purchase price of all goods purchased whether sold or not . . ."

It seems that the statement of "funds" on the cash basis should rigorously follow the cash basis of income

[3] The statement consisting of two columns for comparative balance sheets and two columns for increases and decreases. The net change in the non-capital accounts was balanced against the change in the capital accounts.

recognition. Mr. Myer's Exhibit II of "funds" statement on the cash basis can be restated, in far simpler fashion, as follows:

Cash balance, January 1, 1950		$ 4,261
Cash was increased by:		
Collection of accounts receivable	$83,972	
Sale of furniture	664	
Loan from bank	7,500	
Additional investment by partners	4,000	96,136
		$100,397
Cash was decreased by:		
Payment of accounts payable	$47,421	
Selling, general and administrative expense	27,184	
Interest	405	
Withdrawal by partners	10,450	
Purchase of furniture	1,476	
Purchase of truck	5,000	
Repayment of bank loan	3,000	
Payment of accrued liabilities	111	$ 95,047
Cash balance, December 31, 1950		$ 5,350

Mr. Myer's statement on cash basis (Exhibit IV) shows that cash was increased by sales (both cash and credit) and that the total cash received was reduced because of an increase in accounts receivable. His treatment of cash received from sales on credit is contrary to business practice and elementary bookkeeping techniques. A statement purporting to show changes in the cash balance is too complex if it starts with the accrual basis and attempts to convert to the cash basis of asset flow. The "funds" statement on the cash basis should be recognized for what it is worth; it should rely on the cash basis alone to describe the flow of cash. Actually, one might observe, the "funds" statement on the cash basis as revised and given above is essentially a summary of the cash account.

Sixth, I disagree with Mr. Myer's closing argument in favor of the "funds" statement on the working capital basis. Mr. Myer says that the working capital basis is *broader* and fundamentally more consonant with the accrual basis of accounting and the concept of a continuing business than the "funds" statement on the cash basis. If, for the sake of argument the foregoing points are granted, the statement on the cash basis still serves the vital purpose of describing the flow of cash. The cash and working capital statements have different coverage, are prepared on different bases, and serve different purposes. One is not necessarily superior to the other. Two statements, although different, can be equally useful.

One is forced to wonder how Mr. Myer, who has severely criticized the "backward art of teaching accounting," has departed so great a distance from a simple, useful statement of the flow of cash or working capital.

New York State Tax Forum

Conducted by Benjamin Harrow, C.P.A.

Gross Receipts Tax

The Special Deputy Comptroller continues to hold[1] that the General Business and Financial Tax is applicable to receipts of corporations that make sales within New York City through an independent sales representative, even though the corporations do not maintain offices within the city.

The ruling was based upon a letter requesting a ruling. The letter made reference to the fact that the 1950 legislature amended the law,[2] presumably with the intention of exempting such receipts from the Gross Receipts Tax. The letter also cited the *Norton* case[3] wherein the United States Supreme Court held that the Illinois retailer's occupation tax imposed for the privilege of making retail sales in Illinois violated the interstate commerce clause if it taxed a seller who merely solicited orders in the state either through advertisements or through salesmen. The Comptroller does not regard the *Norton* case as controlling because the Illinois tax was imposed upon total receipts from sales in interstate commerce without any apportionment whereas, under the gross receipts tax, receipts from transactions in interstate commerce are allocated pursuant to a formula that in effect taxes only receipts properly allocable and attributable to doing business within the city.

It might be mentioned that in the *Spector* case[4] the United States Supreme Court held that a Connecticut tax imposed upon the privilege of doing business within the state was unconstitutional if it was levied against exclusively interstate business, even though the tax was presumably fairly apportioned.

It would seem to us that the position of the Deputy Comptroller could not be sustained in the courts. Taxpayers affected by the ruling should therefore consider the advisability of litigating the issue.

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Nature of Payments Received by a Beneficiary in Excess of Estate Tax Valuation

One of the assets of the estate of a decedent was an employment contract which provided among other things that in the event of death the annual salary of $30,000 would be paid to the decedent's estate for a period of ten years. For estate tax purposes this right to receive income for ten years

1 Ruling dated July 30, 1951.
2 Chapter 813, Laws of 1950.
3 U. S. Supreme Court, February 26, 1951.
4 See also New York State Tax Forum, July issue, p. 504.

was valued at $243,326.70 and so taxed. The sole legatee was the widow of the decedent and she received the annual salary payments. In 1941, the widow received a payment of $15,750. In that year the total payments received by her exceeded the estate tax valuation of the contract by $7,923.30. In 1942 and 1943, she received additional payments of $12,000 in each year. The Commissioner determined that the excess payments received by the widow in 1941, 1942 and 1943 represented taxable income. The Circuit Court[5] upheld the Commissioner, but agreed with the taxpayer that the income should be allocated over the life of the contract.

The Court reasons that Sec. 22(a) of the I.R.C.[6] is broad enough to include such payments as income. While property acquired by bequest is exempt from tax, it is only the fair market value of such property at death that is the basis of such exemption (Sec. 113(a)(5)). Anything received in excess of the basis is taxable income.

Since the obligation was to be discharged in periodic payments, the Court held that each payment represented in part a return of capital and in part a return of income. Apparently the Court used the reasoning applied to income from annuities. In its opinion, the Court says at one point that the receipt of an amount due on a contract obligation was *pro tanto* a disposition of the obligation. If that is so the question might be raised as to whether the excess amount received over the basis should not be treated as a capital gain.

The issues raised in this case are equally relevant under the state income tax law.

Franchise Tax—Deductibility of Interest Payable to Stockholders

In determining entire net income where that is the basis of the franchise tax the statute[7] provides that 90% of the interest paid to a stockholder owning 5% of the stock must be excluded as a deduction. This provision was first introduced into the law on May 22, 1937, under old Article 9A. Prior to that date the entire interest paid was excluded.

The Appellate Division recently decided a case[8] where that provision was at issue. The corporation took a deduction of $807,503.98 for interest accrued to two corporate stockholders and showed a net loss for the year. The base year involved was 1936, the privilege year commenced November 1, 1937, and the return was due May 15, 1937. The Tax Commission eliminated 90% of the interest deduction and assessed a tax in excess of $33,000. The taxpayer argued that the statute providing for the exclusion of 90% of the interest became a law eight days after the return was filed and therefore should not be given retroactive effect. The Court was ready to accept this argument but pointed out that the statute as it stood on May 15, 1937, provided for a 100% exclusion of interest paid to stockholders in arriving at entire net income, unless the money was borrowed for the "ordinary expenses of the corporation." Since the taxpayer could not be aggrieved by receiving some deduction where he was not entitled to any, the State Tax Commission was upheld.

Taxability of Income of a Resident who Becomes a Non-resident.

One of our members submits an interesting problem involving this question. A resident of New York sells his business consisting solely of goodwill and reports the profit on the installment basis. In a subsequent year he becomes a non-resident. Is he taxable on the profit resulting from installment payments received during any year that he is a non-resident?

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5 *May D. Hatch* v. *Com'r.*, 2nd circuit, June 29, 1951, rev'g. 14 TC 237.
6 . . . gross income includes gains derived from any source whatever.
7 Section 208, Tax Law.
8 *New Yorker Hotel Corporation* v. *Graves*, 278 A.D. 1003; June, 1951.

The regulations, Article 524, provide that where a taxpayer changes his status from that of a resident to a non-resident the final resident return must be on the accrual basis. However the installment sale probably does not come within this provision since the installment basis is the same for accrual or cash basis taxpayers.

The Tax Commission would probably subject future payments received while a non-resident to tax on the ground that the income was earned in New York while the taxpayer was a resident. This principle was the basis of a court decision[9] taxing a non-resident on renewal insurance commissions where the original commission was earned while the taxpayer was a resident.

The situation is not free from doubt and it may be argued that the installment sale is in a different category from renewal commissions. If that is so the present situation may be a loophole for avoiding the New York tax.

Accrual of Deduction for Real Estate Taxes

The difference between the accounting and legal concept of accrual have resulted in much tax litigation. Generally, the legal concept that the tax accrues as of a single date has resulted in a distortion of income from the accounting standpoint. A recent Tax Court case[10] highlights several phases of the conflicting views of accountants and lawyers.

For the years 1944, 1945 and 1946 the taxpayer paid local real estate taxes as assessed, but immediately protested the assessments by starting proceedings to abate them. In 1947, the taxpayer received some refunds on the amounts paid in earlier years. From the accounting standpoint the income for the earlier years should be corrected to reflect true net income for the applicable period and the taxpayer took that position. The Court however held that the refunds should be reflected as income for the year 1947. This is an obvious distortion of income as the accountant sees it. It should be noted that if the taxpayer had neither paid nor accrued the tax the entire deduction as corrected for three years would be an allowable deduction in 1947.

The case presented a further issue. The taxpayer was on an accrual basis and reported his income on a fiscal year basis ending April 30. The local real estate tax became a lien on January 1st of the year in which assessed. The tax bill disclosing the amount of the tax which depended upon the valuation of the property and the tax rate for the year was not sent to the taxpayer until long after the close of its fiscal period. The taxpayer estimated the amount of the real estate taxes and deducted that estimated amount on its tax returns. The Court held that the return for the particular year must be corrected for the difference between the estimated and assessed amounts of tax. The accountant would probably agree with this finding even though he would take exception to the rule that a full twelve months tax is accruable in this case on January 1st. The taxpayer also argued that alternatively the difference should be taken into account in the next fiscal year when the actual tax for the prior fiscal year was first known and in fact paid. It should again be noted that where a tax is disputed and no deduction therefore is taken a deduction is allowed in the year in which it is paid.

The Court observes that the problem is not free from difficulty. It cites the leading case of *U. S.* v. *Anderson*[11] for the principle that before a deduction for an accrual may be taken all the events determining the liability must

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[9] *Cerf* v. *Lynch*, 237 App. Div. 283 (1932).

[10] *Harbor Building Trust*, 16 TC, No. 159.

[11] 269 U.S. 422.

precede it and the amount must be fixed. It also cites the case of *Continental Tie & Lumber Co.* v. *U. S.*[12] for the principle that where the liability is fixed and where the amount can be estimated with reasonable accuracy the liability may be accrued even though it may be necessary later to correct the estimate by an amended return.

Capital Gains and Losses of a Trust

A recent Tax Court case[13] raised the issue of whether the trust or remaindermen could take a deduction for losses resulting from the sale of securities. The grantor had created a New York trust for the benefit of his wife. Upon the death of his wife the fund was to be distributed to nephews and nieces. The trustee had the power to distribute in kind or partly in kind. Upon the death of the wife the trustee filed an accounting and asked for an order of the court to allow a distribution to the nephews and nieces. Thereafter the trustee sold the securities in the trust in order to make a cash distribution. The sales resulted in losses. The trust did not take a deduction for the loss, but submitted a statement to the remaindermen showing the share of each remainderman in the loss. The remaindermen claimed the deduction which the Commissioner disallowed.

The remaindermen contended that the trust terminated immediately upon the death of the life beneficiary and legal title to the assets vested in them at that moment. The later sale of the securities was therefore made as an agent of the remaindermen. The Court held that the trust did not terminate immediately upon the death of the life beneficiary. The trustee had further duties to perform such as the distribution of the fund and the accounting. Under New York law a trustee is allowed a reasonable time within which to wind up a trusteeship and during that time the corpus continues to be trust property. It continues also for federal income tax purposes. The sale of the securities was an act of the trustee required as a prerequisite to distribution and therefore only the trustee may take the deduction for the loss.

Under Section 365 of the New York income tax law, capital gains and losses are taxable only to the fiduciary regardless of any contrary provisions under a will or trust agreement.

New York City Sales Tax—Rental Libraries and Locker Rentals

Article 100 of the Sales Tax Rules and Regulations provides that receipts from rental fees for the loan of books are subject to the sales tax. The books purchased for rental purposes are not taxable. However, if such books are later sold, such receipts are subject to the tax.

Locker rentals are likewise subject to the sales tax. This would apply to lockers at railroad stations. Starting with May 1, 1951, the tax is not required to be collected on amounts of 18¢ or less.

The sales tax yield for the three months period ending June 30 yielded over 43 million dollars exceeding by 10 million the amount collected for the same period last year. May and June sales were taxed at the present 3% rate.

Penalties in Tax Administration

This was the subject of an address delivered by Spencer E. Bates, President of the N. Y. State Tax Commission, at the 18th annual meeting of the National Association of Tax Administrators, held at Lookout Mountain, Tennessee, on June 6, 1950. The address contained a number of interesting general observations on the subject of penalties in relation to tax delinquencies. It also stated the position of our Tax Commission on this question,

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12 286 U.S. 290.

13 *Coachman* v. *Com'r.*, 16 TC, No. 174; June 29, 1951.

which appears to be a most liberal attitude toward delinquent taxpayers and one calculated to make it easier for such taxpayers to make voluntary disclosures of non-compliance with the law.

At the outset of the talk, Commissioner Bates stated that the "knock their brains out" approach to tax evasion was not his method. He believes a tax administrator gets further and does a better job through a "more reasoned and temperate approach." The emphasis in his opinion should be not in the revenue derived from the penalties but "in their effective stimulation of more adequate compliance with tax laws."

Commissioner Bates noted the inconsistent treatment of penalties under Article 9A and under the personal income tax laws. Under the corporation franchise tax law, the penalty for filing a fraudulent return is 5% of the tax plus interest at the rate of 1% per month. In addition, an officer of the corporation guilty of filing such a return may be penalized up to a maximum of $1,000. The statute also provides a penalty of not more than $5,000 against any corporation which fails to make any report required by the statute.

An individual filing a fraudulent return faces a maximum penalty of 100% of the additional tax plus interest at the rate of 1% per month on the tax and penalty. On an additional tax due of $10,000 the total liability of the corporate taxpayer could be $13,900 as compared with a total of $25,000 in the case of an individual or proprietor of an unincorporated business. (Commissioner Bates used the calendar year 1947 as a basis for comparison.)

Unlike a number of states penalties are discretionary in New York and not mandatory. This has the approval of Commissioner Bates. Tax violators, says the Commissioner, "fall into three main groups:—(1) those who, without intent, fail to report complete information; (2) those who intend to defraud, some of whom are engaged in illegitimate enterprises, and (3) those who make voluntary disclosures."

To do justice to a delinquent taxpayer, each individual case should rest on its own particular merits, says the Commissioner. It is part of the job of a tax administrator, he continues, to face the burden of making difficult decisions in exercising this discretionary power. It makes for equitable treatment and even builds up goodwill on the part of delinquent taxpayers, who are more likely to cooperate with the tax authorities, knowing that the burden of penalties will be eased as a result.

In New York the decision to modify the statutory penalty depends upon the amount of money involved. An associate examiner in the Income Tax Bureau may cancel or modify penalties and interest up to $50 for one year. Administrative supervisors and district tax supervisors may waive any or all interest and penalties up to $250 in any year. The Bureau Director, Deputy Commissioner and Assistant Directors may act on their own, if as much as $1,000 in penalty and interest is involved. Only the Tax Commission may modify or waive penalty and interest if more than $1,000 is involved. While the statute provides for criminal prosecution in actual practice, such action is taken only in the most flagrant cases.

Commissioner Bates paid a fine tribute to the excellent work of the Special Investigations Bureau. At a cost of only $530,000 it had collected $15 million in revenue. He mentions the fact that S.I.B. agents caught an accountant who knew how to make tax returns for his many clients but somehow never got around to paying his own proper tax.

Tax Liens

Commissioner Bates made some extended comments on the relative position of the states and the Federal Government in regard to tax liens. In

(Continued on page 765)

Accounting at the S. E. C.

Conducted by Louis H. Rappaport, C.P.A.

Accountants' Liability under the Securities Act

The liability of accountants who participate in a registration statement filed under the Securities Act of 1933 is spelled out in Section 11 of the law. That section provides, in part, as follows:

> In case any part of the registration statement, *when such part became effective,* contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security . . . may . . . sue—
>
> . . . every accountant . . . who has with his consent been named as having . . . certified any part of the registration statement . . . with respect to the statement in such registration statement . . . which purports to have been . . . certified by him. (Emphasis added.)

The section of the law quoted above makes it clear that the registration statement speaks *as of its effective date.* It means that *when it becomes effective* the registration statement must be true and there must be no material omissions. The law provides, however, that the accountant may avoid liability if he can prove that, after reasonable investigation, he had reasonable ground to believe and did believe in the truth and completeness of the statements made on his authority.

In the February, 1950, issue of this magazine we pointed out the necessity of keeping in touch with the client's financial affairs after the registration statement is filed and before it becomes effective. We also suggested a number of matters which might be considered in a post-filing conference with the client. It is possible that the views we expressed as to the accountant's responsibility may be more severe than would be held by a court if this question were to be litigated. In a 1939 decision involving this question, the court in effect held the accountant not liable for events occurring subsequent to the date of his certificate.

The case is cited *Shonts, et al.* v. *Hirliman, et al.,* and is reported in S.E.C. Judicial Decisions, in the Federal Reporter, and is briefly referred to in the loose-leaf services. According to our information it is the only reported case in which the court had to consider the accountant's responsibility under the 1933 Act for events occuring after the statement date but before the effective date. The decision was in the District Court for the Southern District of California and, we understand, was not appealed to a higher court.

The facts in the case were these: A motion picture company was organized as successor to several predecessors and filed a registration statement on December 30, 1936, with the S.E.C. under the 1933 Act. The certificate of the certifying accountants and their consent were dated December 28, 1936. The company had no material amount of fixed assets and did not own a studio in which to "shoot" motion pictures.

A so-called "delaying" amendment was filed on January 15, 1937, and was followed by a second amendment on January 23, 1937. In this second amendment changes were made in the text as well as in the financial state-

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ments and accordingly a new certificate dated January 19, 1937, and a consent were signed by the certifying accountants. A third amendment was filed on February 1, 1937, but apparently no changes were made in the financial statements because a new accountants' consent was not filed. The S.E.C. declared the registration effective on February 3, 1937, as of January 19, 1937. After the effective date more amendments were filed. Some of the stock had been sold when the S.E.C. instituted stop order proceedings. On May 11, 1937, the Commission issued a stop order suspending the effectiveness of the registration statement (2 S.E.C. 292), and preventing further sales of the stock.

Some of the people who purchased the shares brought suit against certain officials of the corporation and the certifying accountants. The actions were to recover damages (the price paid for the stock) under Section 11 of the 1933 Act, alleging falsity in the registration statement. The falsity relied on by the plaintiffs related to misrepresentations and omissions concerning a lease between the motion picture company and the owner of a studio, and the failure to set forth in the amendments to the registration statement that the motion picture company was obligated under the lease to use the studio a minimum of 100 days a year at a total rental of $35,000.

The evidence showed that a formal lease was not entered into until March 9, 1937. However, a telegram signed by the studio president, dated January 31, 1937, committed the company to a rental arrangement to be followed by a formal leasing. This telegram indicated that the studios were rented for $350 per shooting day but did not refer to a minimum guarantee. The formal agreement of March 9, 1937, committed the motion picture company to shoot at least 100 days a year at a rental charge of $350 per day while in the studio and $175 per day while on location. The judge said he was satisfied that the omission from the statement of the minimum requirements in the lease, which obligated the picture company to shoot at least 100 days a year, was material. The judge continued:

> "It is not of any great significance that the lease was not actually entered into until later. For that reason, I am of the view that there is no falsity in the statement that they had certain rental arrangements with a particular company. I think the oral negotiations and the telegram of January 31, 1937, showed a commitment which the parties themselves considered binding, and which was to be later embodied in a more formal instrument. The effect of these conclusions is this: No misstatement or omission appears in the registration statement until after the last certificate of [the certifying accountants], dated January 19, 1937. Prior to January 31, 1937, there were merely discussions of rental, and no definite undertaking by either side or guarantee of a minimum which was binding on the company. The failure of the certificate of [the certifying accountants] to set up the rental undertaking and the minimum guarantee of $35,000 as a contingent liability, is not the omission of anything which existed then. The rental arrangement was not called to their attention. There was no entry on the books at their disposal, from which, by further inquiry, they might have discovered that there was such an undertaking. Absent these, they cannot be charged with a misrepresentation which was made later—long after their certification."

As to the accountants the judge concluded:

> "In sum, we cannot, as to [the certifying accountants], take the subsequent omissions and retroject them to the date of January 19, 1937, so as to "tie" them to a certificate, which they made on the basis of facts as they then existed and which showed no rental arrangement of any kind."

If the telegram confirming the lease arrangement had been dated prior to the date of the accountants' last certificate, would the judge have upheld the plaintiffs as against the accountants? Is there any significance in the fact that the registration statement was declared effective on February 3, 1937, as of January 19, 1937? These are interesting questions but we don't know the answers.

An article which appeared in the *Yale Law Journal* in 1940 commented

on this case and made the following very interesting observation:

> "The court in this case thus set out as reasonable an investigatory standard far below that which is customary in the profession and necessary for the detection of possible contingent liabilities, which must be listed in the registration statement. The usual investigation, it appears, would include securing information from the responsible corporate officials as to the extent of any contingent expenditures, legal opinions on the possibility of damages being assessed against the company as a consequence of any pending litigation, and the inspection of the minutes of stockholders' and directors' meetings. It is true that the discovery of such contingent liabilities is among the most difficult problems facing the accountant, but the accountant, alone, will be able to bring to light these items of potential importance to security buyers, and he should therefore be fully liable for any failure to take whatever means are available and customary in discovering any such concealed obligations."

The *Shonts* case, as we have said, is an old one, but it is the only reported case bearing on the question of accountants' responsibility under the 1933 Act for events occurring after the date of the financial statements and before the effective date of the registration. The case is not a satisfactory one and raises almost as many questions as it answers. Until there is a better case, we shall hold to the opinion that, under the 1933 Act, prudence requires the certifying accountant to keep in touch with the financial affairs of his client up to the effective date of the registration statement.

New York State Tax Forum

(Continued from page 762)

bankruptcy proceedings tax liens held by a state are, in general, on a parity with federal tax liens. But where the federal government or one of several states audits a return of a taxpayer and finds an additional tax due, the federal government has absolute priority over the states in collecting the additional tax and penalties if the taxpayer is unable to pay the entire amount due to the various taxing authorities. There may be an exception to this rule if the state has perfected its inchoate lien although this is unsettled according to Commissioner Bates. The Commissioner suggests that in the public interest all governments should have equal standing in this matter of collection of taxes. He suggests legislation which would make possible a proration where assets are insufficient to make payment in full, just as is done in bankruptcy cases.

The spirit of the address is well summarized in the final paragraph. "Our free, democratic society will never be imperilled by the tax collector so long as he remembers that it is his solemn obligation to defend the constitutional rights of the taxpayer with the same vigor that he exerts in protecting the interests of the State he serves."

Notes on the New York State Unemployment Insurance Law

Conducted by Samuel S. Ress

Joint Accounts for Merit Rating

Two or more qualified employers can apply for the establishment of a joint account pursuant to Rule 12, recently promulgated by the New York State Unemployment Insurance Division.

A qualified employer is one who has been subject to the New York State Unemployment Insurance tax for fourteen consecutive completed calendar quarters immediately preceding July 1st of any year and must have paid some remuneration to employees and filed contribution reports in the calendar year immediately preceding July 1st.

The employers who wish to establish a joint account need not be in the same or related industry nor are they required to have common ownership or management. Any group of qualified employers can pool their experience for Unemployment Insurance Tax purposes.

Unemployment Insurance benefit charges will be levied against the pooled account as though it were the account of a single employer. The tax rate will be computed for the pooled account and apply for all firms in the joint account.

Rule 12 reads as follows:

"a. A joint account shall be established upon the application of any two or more qualified employers. Such joint account shall be maintained as if it constituted a single employer's account. The rate of contribution applicable to the joint account shall be computed as of the computation date in the preceding calendar year, and such rate shall apply from the first day of the calendar quarter in which the application was made to the end of that calendar year.

"The rate of contribution applicable to the joint account with respect to the calendar year following the calendar year in which the application was made shall be determined or redetermined as of the computation date in the calendar year in which the application was made. In establishing the age factor of the joint account, the 'years of liability for contributions' of the joint account shall be computed by adding the number of full consecutive years preceding the computation date during which each employer has been liable for contributions and dividing the result by the number of employers involved."

"b. A joint account may also be established between an employer qualified for rate credits as of September thirtieth, nineteen hundred fifty and other employers not qualified for rate credits as of that date if some of the employees of the employer so

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qualified have been transferred to such other employer or employers on or prior to July first, nineteen hundred fifty-one, provided the functions in which they were engaged and the assets, if any, relating to such functions are also transferred to such other employer and further provided the transferring employer discontinues such functions upon the transfer. Experience of employers so affected shall be combined and such employers shall for all purposes of this section be treated as if they had operated as a single employer. For the purpose of establishing an initial account balance, the age factor shall be established by adding the age factors which apply to each of such employers whether or not any of them, considered separately, would be qualified employers and by dividing the result by the number of employers involved."

"c. A joint account may also be established among employers not qualified for rate credits as of September thirtieth if an employer qualified for rate credits as of such date has transferred all or substantially all of his assets to two or more employers on or prior to July first, nineteen hundred fifty-one and discontinued operations upon such transfer, provided the employers to whom the assets are transferred are liable for contributions as of the date of the transfer, and further provided that all employers to whom such assets were transferred join in an application."

"The experience of all such employers to whom such assets have been transferred shall be combined and such employers shall for all purposes of this section be treated as a single employer. For the purpose of establishing an initial account balance, the age factor for such joint account shall be established by adding the age factors which apply to each such employer and the age factor of the transferring employer whether or not any of them, considered separately, would be a qualified employer and by dividing the result by the number of employers involved."

"d. The rate of contributions applicable to the joint accounts established under sections b and c above shall be computed at such times and in the manner prescribed by section a of this rule."

"e. Joint accounts established under sections b and c above shall for all purposes of this rule be treated as a single qualified employer and may join with other qualified employers in a joint account."

"f. Any joint account shall be dissolved upon the filing of an application by one or more of the employers included in such joint account. The rate of contribution applicable to the accounts of the employers included in such joint account shall be respectively determined or redetermined as of the computation date in the calendar year in which such application is filed, and such rates shall apply as of the effective date occurring in such calendar year."

Some Recent Appeal Board Decisions

The new Unemployment Insurance Experience Rating provisions make the employer an interested party in every Unemployment Insurance benefit claim made by one of his former employees. An employer who is dissatisfied with a a determination granting an Unemployment Insurance benefit payment to a former employee, may request a hearing to dispute the claimant's right to Unemployment Insurance benefits. The employer's request for a hearing must be accompanied by a $10.00 deposit which will be returned to the employer only if the Referee modifies or reverses the decision of the Industrial Commissioner to pay the benefit. An employer who disagrees with the Referee's decision may appeal to the Unemployment Insurance Appeal Board and pay a $25.00 deposit with his Notice of Appeal. The deposit will be returned only if the Referee's decision is modified or reversed. It becomes important to employers therefore, to be familiar with the more important rules pursuant to which benefit claimants may be suspended or disqualified from receiving Unemployment Insurance payments.

1. If a claimant quits the job without good cause but is actively seeking other work, he may not make a valid claim for benefits until he registers at an Unemployment Insurance Office and serves a six-weeks suspension period. There have been many decisions handed down by the Appeal Board and the courts in determining whether "good cause" exists.

From time to time some of the more interesting and relevant decisions will be discussed.

2. If loss of employment is due to misconduct in connection with the job or due to an industrial controversy in the establishment, a valid claim may not be filed until seven weeks after employment ended.

3. If a claimant refuses a suitable job without good cause he is disqualified for that entire period of unemployment.

4. If a claimant is not available for work he is disqualified until he demonstrates he is available.

If an employee quits and withdraws from the labor market, he will be disqualified as unavailable and should he at some later date apply for Unemployment Insurance, certifying and demonstrating that he has reentered the labor market, the last employer will be queried at that time and the reason for the separation examined to determine whether it was without good cause.

Appeal Board Case #26 720-51, dated August 24, 1951, illustrates a case where a claimant was found to have quit her job without good cause. The claimant was employed for eight years as a payroll clerk in a steel mill. The payroll department consisted of the claimant, a male payroll clerk and the chief. The claimant's work was similar to that of the male payroll clerk. He had one year more seniority than the claimant, and in the absence of the supervisor, he exercised supervisory authority. He also had several years of accounting experience and was considered to have more analytical ability than the claimant. His salary was slightly higher than the claimant's.

After an extensive time study and job analysis that had been made of the numerous functions of the employer's establishment, a reclassification of the various jobs was made effective September 1, 1950. The claimant's position was reclassified to payroll clerk "B" and she was given an increase in salary. However the male payroll clerk was reclassified as payroll clerk "A" and his new salary was $32.00 a month more than the claimant's.

The claimant resented the fact that her job was reclassified lower than that of the male payroll clerk and when her employer refused to change her reclassification, left her job on October 13, 1950. She filed for Unemployment Insurance benefits on October 30, 1950. The Industrial Commissioner ruled that she was disqualified from receiving benefits for 42 consecutive days from October 30, 1950, on the ground that she voluntarily left her employment without good cause. At a hearing before the Referee, the Industrial Commissioner's determination was overruled. The Appeal Board reversed the Referee's decision and upheld the Industrial Commissioner.

The Appeal Board pointed out that the Referee's decision was based upon a finding that the claimant was justified in leaving her job because she received an inferior classification due to her sex. The Appeal Board stated that the credible evidence failed to support any justification for the Referee's finding. The Appeal Board further stated that the claimant's employer had the right to make a reclassification after a careful and exhaustive analysis of the various jobs in the employer's establishment and that the claimant was not justified in leaving her position just because she was disappointed in her reclassification. The Appeal Board found that the main reason the male payroll clerk was given a higher rate than the claimant was because of his better training experience and qualifications and that the sex of the employee was not given any consideration in the job analysis and furthermore that the results would have been the same regardless of the claimant's sex. It was held therefore that the claimant voluntarily left her employment without good cause and the Industrial Commissioner was justified in disqualifying the claimant from receiving benefits for 42 consecutive days from October 30, 1950.

* * *

Another case, Appeal Board Case #27-896-51, dated August 24, 1951, demonstrates a situation in which a claimant was disqualified from receiving benefits on the ground that without good cause she refused employment

for which she was reasonably fitted by training and experience.

The Industrial Commissioner had also ruled that the claimant was unavailable for employment. The claimant had filed a claim for benefits and registered for employment on November 30, 1950. She had been employed for about seven years ending on June 19, 1950, as a head-bookkeeper. In this employment she had supervised two assistant bookkeepers and performed the usual duties of a full-charge bookkeeper, except that she did not work with the general ledger or take off trial balances. Her terminal salary was $75.00 a week plus bonuses. She resigned because of pregnancy and gave birth on September 17, 1950. In 1944, the claimant had been employed by another employer where she had general ledger work and took off trial balances in addition to her duties as a full-charge bookkeeper. The claimant was classified in an employment office as an assistant bookkeeper and on February 2, 1951, was offered a job in that category at a salary of $55.00 a week. The claimant refused this offer of employment on the grounds that the salary was insufficient and further that she is not an assistant bookkeeper. Thereupon, the Industrial Commissioner issued an initial determination which disqualified her from receiving benefits on the ground that the refusal was without good cause. At the hearing before the Referee, the Industrial Commissioner amended the initial determination to include a finding that the claimant was unavailable for employment because of salary restrictions.

She had indicated that she would not consider any offer of employment at less than $70.00 a week. The prevailing wage unit of the Bureau of Research and Statistics of the State of New York reported that the majority of full-charge bookkeepers earned from $55.00 to $72.00 a week. The Appeal Board held that the claimant was erroneously classified as an assistant bookkeeper by the Employment Service and that she should have been classified as a full-charge bookkeeper. The claimant's skills and employment history which included general ledger and trial balance work justified her estimate of the type of work for which she is best qualified.

The acceptance of an assistant bookkeeper's job would not have utilized her best skills and would tend to depress her wages. However the Appeal Board found that she was unavailable for employment as a full-charge bookkeeper so long as she restricted her minimum salary requirements to a job paying at least $70.00 a week. In view of the evidence submitted by the Bureau of Research and Statistics which indicated that the majority of full-charge bookkeepers earned from $55.00 to $72.00 a week, the Appeal Board decided that the claimant should not be disqualified from receiving benefits on the ground that she refused employment for which she is reasonably fitted by training and experience, without good cause. However they did find that she was unavailable for employment so long as she continued to maintain the $70.00 minimum salary requirement. The effect of this decision was to make the claimant eligible for benefits as soon as she indicated that she was willing to remove the $70.00 minimum salary requirement.

If the Appeal Board had found that she had refused employment without good cause then she would not have been permitted to receive any Unemployment Insurance benefits throughout her entire period of unemployment.

Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by Max Block, C.P.A.

Tax Department Mechanics

A considerable amount of interest has been evidenced by accountants in the subject of tax department mechanics discussed in last month's column. This subject was also discussed at the September meeting of the Office and Staff Management Group.

Apart from the physical aspects of the handling of a return in the processes of preparing, reviewing, typing, proofreading, assembling, and mailing it, there also are the accuracy controls. What is the best way to prepare and review returns in the shortest period of time yet insuring the maximum accuracy and savings?

The following thoughts are offered in this connection.

1. Staff men assigned to the preparation and review of tax returns must be qualified to do so. Those who prepare business tax returns throughout the year, and those who are conscripted for the preparation of personal income tax returns during the early months of the year, must know the tax law, regulations, and the common problems of each type of tax return.

This can be accomplished by the following means:

(a) Tax literature must be made available to staff to keep them posted on current rulings, decisions, and changes in the laws and regulations.

(b) Bulletins should be furnished to the men, from time to time, bringing out the highlights of important tax decisions and changes, to insure understanding and to point out the practical effects thereof and how they should be applied for the benefit of clients.

(c) Staff meetings for the discussion of tax cases, review of the law, peculiar requirements of the various tax returns, tax pitfalls, tax saving ideas, and other pertinent tax matters.

Before each personal income tax period a refresher course should be given to those assigned to such work. Pamphlets published by the various tax service companies should be distributed among the men as required reading. In addition, the physical aspects of the preparation and disposition of returns should be discussed to obtain the fullest possible compliance with the established procedures.

It doesn't matter whether the staff consists of two, 20, or 200 men. There must be a sound approach to the important task of tax return preparation.

2. Check lists covering points to be observed in the preparation of returns should be prepared for each type of return. Do not trust all to memory. Such a check list would include provision for referring to prior years' returns (or summarized data) for carry-overs, tax examination changes of prior years affecting the current year, inquiry into non-taxable income and non-deductible expenses, items not on records which must nevertheless be taken into the returns, and numerous other situations which should be covered.

3. A check list for the benefit of reviewers should be prepared. The steps they should follow in review should not all be left to memory.

In the October, 1951, issue of the Journal of Accountancy there is an excellent article entitled "Reviewing

the Corporate Federal Income Tax Return" by Jackson L. Boughner, C.P.A. It is a good illustration of the value of the check list (called a questionnaire in the article) and sets forth and comments on the contents.

Though the time involved in the initial preparation of such check lists may be considerable, they will pay off most generously thereafter in time saved, greater accuracy, and better tax results. This applies to the smallest individual accounting practice as well as to the large.

The Editor would be happy to receive samples of check lists in use for publication in this column.

Fireproof Files and Cabinets

Fire insurance companies claim that 43% of all companies whose records are destroyed by fire do not reopen—presumably for that reason. It is not likely that accountants would necessarily suffer such a fate. But the embarrassment, annoyance, and client ill-will, like the memory of the fire, might linger on forever, or a mighty long time in any event.

A sense of complacency develops among accountants as well as others about such protective matters. Particularly in view of the present state of emergency, this problem is more acute.

Accountants would be wise to determine how "fireproof" their present metal files and cabinets really are. There are enormous differences in the ability of metal cases to withstand fire and heat, and water too, for varying periods of time. Certainly the most important papers should be kept in the safest files and cabinets.

It is also possible to carry record-loss insurance. This would compensate for losses and expenses attributable to the destruction of the records.

Tax Problem in Partnership Agreements

Members of accounting partnerships should give consideration to the tax status of retirement and death benefit provisions in their agreements. This is particularly applicable to those cases where the provisions are based on the assumption that there cannot be any transferable or salable goodwill in a professional partnership. That concept has been shattered by the decisions in the cases of *Horton,* and *Wyler.* Though these cases dealt with the sale of an accounting practice, nevertheless they clearly establish that goodwill may exist in a personal service business.

Retirement and death benefits may be construed as payments for goodwill where the firm's position, the amount paid and the formula for its computation, the language of the partnership agreement, and the existence of goodwill factors generally recognized by accounting and tax practitioners, can be found to support such a view. Even the existence of a disclaimer provision may not necessarily be sufficient if other provisions and circumstances negate it.

The tax consequences of payments being held to be for goodwill are very obvious, namely, that they will be considered non-deductible for income tax purposes.

It does not follow, however, that payments for partners' retirement and death benefits necessarily represent the purchase of goodwill. This can be determined only from the intent of the agreement, its provisions, and the other pertinent factors in each case. The use of life insurance as a means of financing such transactions is a common practice. One must determine whether such action may not have an implication that it is for the acquisition of an intangible asset. Where it is used to finance the payment of the balance due a partner according to his capital and profit share accounts, then all that is involved is the payment of a debt. If it is for something in addition, then what does it constitute?

Unfortunately, partners may not have tax-recognized pension plans, though attempts to bring that about

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The Excess Profits Tax Exchange

Conducted by David Zack, C.P.A.

This column is a clearing house for questions, problems and comments regarding Excess Profits Taxes. Items of general interest will be published herein and full credit will be given all contributors unless they request otherwise. All inquiries and contributions should be addressed to:

Editor, The Excess Profits Tax Exchange
The New York Certified Public Accountant
677 Fifth Avenue
New York 22, N. Y.

New Corporations

One of our members submits the following practical problem. The reply is based on the current law as this is being written before the enactment of the Revenue Act of 1951.

"A corporation was organized January 20, 1947, and closes its books on a calendar year basis. An excess profits tax return was filed for the calendar year 1950 based on the industry's rate of return on its total assets as of December 31, 1949, plus its capital additions and its increase in average borrowed capital for the calendar year 1950. How is its excess profits tax credit computed for the calendar year 1951 and future years? In addition to the industry's rate of return on its gross assets as of December 31, 1949, is that credit increased by the increases in capital and average borrowed capital for both 1950 and 1951 or just for the calendar year 1951? If just for 1951, what happens to the increases in capital and borrowed capital for 1950? If both years, exactly how are the increases averaged for both years 1950 and 1951? I presume the method to be used for 1951 would similarly apply to future years."

David Zack, C.P.A., is a member of our Society and of its Committee on Federal Taxation. He is Chairman of the Committee on Municipal and Local Taxation.

Mr. Zack is a member of the New York Bar, the Federal Bar, and the Tax Bar. He is a Lecturer on Taxation at The City College (N. Y.) School of Business and Civic Administration where he developed an intensive course on the New Excess Profits Tax Act.

Mr. Zack has written on tax matters for various publications. He is engaged in tax practice with a prominent New York firm of certified public accountants.

There are two distinct rules for the computation of the excess profits credit for a corporation under Section 445 of the Internal Revenue Code. There is one rule for the taxpayer's first three taxable years (Sec. 445(b)(1)) and a different formula for subsequent years (Sec. 445(b)(2)). Since the corporation in issue was organized on January 20, 1947 and presumably commenced business on or about that date, its first three taxable years would be 1947, 1948 and 1949. We are therefore concerned with the second rule for 1950 and thereafter.

Section 445(b)(2) computes the average base period net Income for taxable years after the first three by applying the industry base period rate of return to "total assets" at the later of the following two dates: (1) The last day of the year before the taxpayer's first excess profits taxable year, or (2) the last day of the third year after the taxpayer commenced business. In the instant situation, both of these dates fall on December 31, 1949. The taxpayer must therefore apply its industry rate of return to its total assets on December 31, 1949 and subtract the interest paid or incurred by it during the calendar year 1949.

Section 445(e)(2) provides that new corporations beyond their first three years compute their net capital

addition or reduction from the same date as of which the total assets are taken,—December 31, 1949 in this particular case. There is no need for averaging 1950 and 1951 or any later year, the net increase or decrease is simply figured from December 31, 1949, to the current year for which the return is being prepared.

Acquiring Corporations and Change in Products or Services

An upstate reader submits the following interesting question:

> "Taxpayer 'A', an individual, was sole owner of a hotel acquired by him in 1945, which he leased to an operating partnership consisting of himself and two other individuals. In 1947 the partnership discontinued operations and dissolved. Taxpayer 'A', who still owned the hotel, formed a new corporation and transferred the hotel properties to it in exchange for all of its stock. The corporation thereafter owned and operated the hotel for the remainder of the base period. (Note that the two other partners were entirely eliminated.)
>
> "Under the facts above stated, is the corporation an acquiring corporation under the 1950 Excess Profits Tax, or does it qualify as a new corporation formed in the base period?
>
> "If it is an acquiring corporation, does Section 443 relating to changes in products or services, apply?"

Section 461(f) considers a sole proprietorship to be a partnership for the purposes of Section 461(a)(1)(D). The latter section qualifies a corporation which has received substantially all the properties of a partnership in an exchange to which Section 112(b)(5) is applicable as an "acquiring corporation". Since the question indicates that taxpayer "A" apparently transferred the hotel to the corporation for stock in a transaction that would be tax-free under Section 112(b)(5) of the Internal Revenue Code, the corporation is an acquiring corporation under the Excess Profits Tax Act of 1950.

Since the "component corporation" commenced business on or before the first day of the taxpayer's base period, the acquiring corporation might qualify for relief under Section 443 if it could establish that it had a substantial change in products or services during the last 36 months of its base period.

Excess Profits Net Income

If the Excess Profits Tax Act of 1950 is not sufficiently complex to impress most practitioners, we have the added feature of ambiguous semantics to confuse the skeptical reader. The common term "excess profits net income" has at least a half dozen different definitions under various sections of the law and an unwary reader may be easily confused, to put it mildly. A tentative list of definitions is submitted hereunder; additions are solicited.

(1) Excess profits net income for the current taxable year—Section 433(a).

(a) Excess profits net income—Invested Capital Method—Section 433(a)(1)(N).

(b) Excess profits net income—Income Method—Section 433(a)(1)(O).

(c) Excess Profits Net Income—Historical Method — Section 433(a)(1)(J).

(2) Excess profits net income for base period years—Section 433(b).

(3) Excess profits net income for current taxable year and base period years for certain instalment and long term basis taxpayers—Section 455.

(4) Excess profits net income under the relief sections—Sections 442-446.

In the case of taxpayers using the income method and having fiscal years ended after June 30, 1950, and before December 31, 1950, we have the anomalous situation of two different excess profits net incomes (under Section 433(a) and 433(b)) being computed for the same taxable year, since portions of the same year serve as part of the base period and the current taxable

(Continued on page 775)

CORRESPONDENCE

To the Editor of *The New York Certified Public Accountant:*

For practical reasons, this note is best dressed in a cloak of anonymity. Its purpose is to take the staff men off a pedestal on which Mr. T. H. Carroll seemed to put them in August.

I am a member of the Society and have joined the ranks of many who have transferred to private industry. We go along with the idea of client preparation for the audit and do substantially as suggested by the author in his paper in the August, 1951, issue. However, on page 532 he urges a cooperative attitude to avoid antagonism, with the thought that it is primarily the client's problem.

To a point, I concur but I do think that the members of the auditors' staff frequently create an unwarranted annoyance. The client has to run a business for 12 months of a year and not just for an audit. He must have information available and it is his problem to get it in the easiest way. He must file reports, many of which have a deadline shortly after the close of his fiscal year, especially if that is December 31.

My suggestions are to guide the staff seniors more closely as I was guided by a brilliant man who is still in public work:

1. Wait until the client makes adjustments in ledgers before taking trial balances, if the client is the type who adjusts accounts. That saves posting many journal entries in working papers. For example, we start in the front of the ledger and go through each account, making corrections if they are required; all of them can't be complete at once. I formerly opposed postponement of trial balance until I found how it saved time.
2. Don't try to analyze an account if the client indicates that he knows that adjustments are needed and that he is hurrying along to them. For instance, deferred charges (such as insurance) often need attention but are relatively unimportant in total on the balance sheet, so they are left to last. Let the auditors arrange their program accordingly.
3. Stop running in with errors of $10-$100. Don't make a great to-do. I have had some do that and since it was on a tax return or accrual, the dollar value was small after applying the tax percentage.
4. Get the staff to learn the relative importance of matters. The market value of some bonds (only a parenthetical item of small amount) was in error by $20 on a bid and ask quotation. Some fun when the senior got a quote from another source!

I know from experience on both sides—and I sometimes regret it—that antagonism is awful. But please let us CPAs take their share of the responsibility for alleviating the condition and not throw the ball to the client for all the errors.

Ed. Note: Our anonymous correspondent states, in his second paragraph that Mr. Carroll "urges a cooperative attitude to avoid antagonism, with the thought that it is primarily the client's problem." A reference to the article should dispel any such connotation quickly. There is no inference that the problem is primarily the client's; indeed Mr. Carroll says that it concerns both the client and the auditor.

Since the auditor is present to inquire into and to observe facts, it would seem that any annoyance, warranted

or unwarranted, is almost surely more apt to occur in the mind of the audited than that of the auditor, and should of course be carefully guarded against. As a matter of fact, in most accounting organizations, the members of the staff are generally instructed to avoid any action or speech which might create a lack of cooperation.

There is one other point worthy of mention: The time schedule under which an auditor works is usually not of his own choice; often it is not even the client's. Bankers, attorneys, and other interested parties sometimes compel the completion of an engagement by a certain deadline. If, for example, the indenture covering a loan should require certification by a particular date, too often the burden of completion seems to rest solely upon the auditor.

We hope that this exchange will help clear the way to a better understanding of a joint problem.

Office and Staff Management

(Continued from page 771)

are under way. However, it is not illogical to provide for reduced activity by partners after a certain age or years of employment. They can be retained as advisory partners and be compensated at a reduced basis for as long as they are alive and able to serve the firm. Such payments should be tax deductible.

In the case of long established, highly reputed, profitable firms, the payment of death benefits which will not be construed to be the equivalent of a purchase of goodwill, in part or in full, requires astute and careful planning. In any event its success cannot be assured. This phase will be discussed further in a future issue. In the interim, the Editor will be pleased to receive, and publish for the benefit of those struggling with the problem, any plans presently in use that may be considered appropriate for the tax objective.

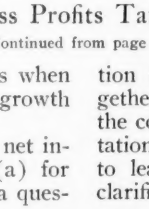
The Excess Profits Tax Exchange

(Continued from page 773)

year. The same spectacle arises when relief is computed under the growth formula in Section 435(e).

The variety of excess profits net income provided in Section 433(a) for the current taxable year raises a question as to which should be used together with the minimum credit and in the computation of the maximum limitation. The entire situation would seem to leave a little room for legislative clarification.

NOTE: Any answers to questions contained herein represent the opinions of the author and are not promulgations by the Society.



OFFICIAL DECISIONS *and* RELEASES

Price Level Changes and Financial Statements

SUPPLEMENTARY STATEMENT NO. 2*

COMMITTEE ON CONCEPTS AND STANDARDS UNDERLYING CORPORATE FINANCIAL STATEMENTS

American Accounting Association

ONE of the conventions presently underlying corporate accounting is the assumption that fluctuations in the value of money may be ignored. Business transactions are recorded in terms of a nominal monetary unit, and accounting statements exhibiting business results and financial position similarly employ the monetary unit as a common denominator.

As traditionally measured, accounting net income expresses the excess of periodic revenue over the cost of the capital (resources) "consumed" in earning that revenue. Under the present monetary postulate, the "costs" charged against revenue in measuring net income are, in general, dollar costs—the number of dollars initially invested.

With changing price levels, however, the value of the dollar does not remain stable; within the economy as a whole its average purchasing power fluctuates continuously.[1] Under the impact of the price level changes of recent years, challenges have arisen as to the adequacy, for many purposes, of the conventional method of measuring net income. Some accountants contend that the principal significance of dollars lies not in their number but in their purchasing power, and that, when the value of the dollar changes, accounting measurements of business costs should be modified accordingly. They propose, therefore, that the orderly evolution of accounting now requires, as an extension of present practices, the reflection in financial statements of all items of revenue and cost on a "common dollar" basis. They contend that experience amply demonstrates that money as a standard of value is an unstable variable; that in many cases the balance sheet represents the assembly of basically non-additive amounts; and that income calculations are distorted by the failure to place all amounts on a uniform dollar value basis.

The proponents of modification are not in agreement, however, as to the methods by which the effects of variation in the value of the dollar should be measured, or as to the manner in which these effects should be disclosed in corporate financial statements.

Accountants who oppose modification contend that the conventional treatment is deep-rooted in practice, in law, and in general understanding; that the significance of the problem is exaggerated; that the variations in the value of money are compensated for in part by other factors; and that any change in practice not supported by general demand would result in irregularity of application and in confusion.

The 1948 Statement on Accounting Concepts and Standards Underlying Corporate Financial Statements, in a footnote, opposed departure, at that time, from historical costs:

* August 1, 1951.

[1] Fluctuations in the United States Bureau of Labor Statistics Index of average for the year wholesale Prices:

1913— 69.8	1932— 64.8	1946—121.1	1949—155.0
1920—154.4	1939— 77.1	1947—152.1	1950—161.5
1926—100.	1945—105.8	1948—165.1	1951—182.8 (May)

"Readers of financial statements may be aided in their interpretations by considering the effect of fluctuations in the purchasing power of money. A marked, permanent change in price levels might impair the usefulness of statements reporting asset costs; however, price changes during recent years do not afford sufficient justification for a departure from cost. Accounting concepts and standards appropriate for the reflection of a drastic and permanent change in prices would need to be developed in the event of such a change."

In reconsidering the subject at the present time, the Committee does not believe it necessary to weigh or even to state all of the arguments for or against the adoption of the "common dollar" proposal. Ultimately, the desirability of change will be determined by the usefulness of any projected corrective procedures; this in turn will depend largely upon the significance of the problem, a matter not yet fully established by objective measurement.

In order to clarify the problem and to suggest a course of action, the Committee has considered these questions:

(1) Is modification of the conventional accounting approach to net income determination to give explicit recognition to changes in the value of the dollar a desirable development?

(2) If so, what methods are most appropriate for measuring variations in the value of the dollar and for giving effect to such variations in financial reports?

(3) If such modification is desirable, how is disclosure best to be accomplished?

This Supplementary Statement No. 2 sets forth the conclusions and recommendations of the Committee.

THE QUESTION OF MODIFICATION

Conclusions

(1) *In periodic reports to stockholders, the primary financial statements, prepared by management and verified by an independent accountant, should, at the present stage of accounting development, continue to reflect historical dollar costs.*

(2) *There is reason for believing that knowledge of the effects of the changing value of the dollar upon financial position and operating results may be useful information, if a practical and substantially uniform method of measurement and disclosure can be developed.*

(3) *The accounting effects of the changing value of the dollar should be made the subject of intensive research and experimentation; the specific significance of the basic problem should be determined with as much accuracy as possible; the means of its solution, if its significance warrants, should be thoroughly investigated.*

Discussion

Conventional accounting practices, which include adherence to historical dollar costs in financial reporting, have evolved over a long period. The usefulness for certain purposes of data so derived is well established. A complete and abrupt shift to an alternative basis at the present time is believed to be both inappropriate and impractical for several reasons:

(1) A vast body of common and statutory law and legal precedent, innumerable contractual and business relationships, and many regulatory provisions are presently founded on existing accounting practices.

(2) Although the upward movement of prices has occasioned an increasing general awareness of the instability of the dollar as a unit of value measure, there is no clear indication that businessmen, stockholders, employees, and the general public either desire or could now accept, without considerable confusion, any departure from historical cost.

(3) There is a lack of substantial agreement as to methods by which purchasing power adjustments may be accomplished; experimentation with specific methods has been inadequate. General acceptance of a proposal that present accounting methods be changed demands a clear demonstration of

practical utility, which in this case is not yet available.

(4) Recorded and summarized historical dollar costs appear to provide the only adequate starting point for the development of information which will reflect the effects of changes in the value of the dollar.

These reasons are deemed sufficient to sustain the conclusion that, at the present stage of accounting development, the primary financial statements should continue to reflect historical dollar costs.

It does not follow, however, that such primary statements constitute the only financial information that should be presented in financial reports. For many purposes wide fluctuations in the general price level (changes in the value of the dollar) may place severe limitations on the validity, and, therefore, on the usefulness of statements based on historical dollar costs. Under such circumstances, the income statement reflects revenue expressed automatically in "current" dollars, while the cost of earning that revenue is expressed in dollars of widely varying purchasing power; the balance sheet, too, represents an assembly of items similarly measured in varying dollars. While historical dollar cost statements are essential even in periods of major price change and may be adequate for some purposes, there is substantial evidence that important informational benefits would be derived from a restatement of accounting data in terms of a monetary unit of uniform significance—should an acceptable means of adjustment and presentation be developed. These benefits would stem from the elimination—or segregation—of one hitherto unknown variable, the fluctuation in the unit of measure.

While corporate reports are typically prepared primarily for stockholders, the information therein presented becomes, in effect, public property, and may enter quite generally into the formation of judgments. Financial statement data expressed in uniform "current" dollars would seem to be useful for the following purposes:

(1) The appraisal of managerial effectiveness in terms of the preservation of the current dollar equivalent of the capital invested in the business and not merely its initial dollar amount;

(2) The analysis of earning power in terms of the current economic backdrop;

(3) The determination and justification of sound wage policies; negotiations with labor unions;

(4) The determination by government of long-range policies with respect to "control" of the economy through monetary policy, price regulation, limitation of profits, taxation, etc.;

(5) The creation of an informed public opinion with respect to profits, prices, wages, etc., and the effect of inflation (or deflation) upon financial relationships generally;

(6) The determination of managerial policies with respect to pricing, credit, dividends, expansion, and the like.

That the value of the dollar does fluctuate substantially is revealed by published general price indexes.[2] That this fluctuation has created an accounting and reporting problem of material significance has been less fully demonstrated. No specific objective method of measurement and adjustment applicable to all situations has been devised and widely adopted. Hence, accurate estimates are difficult; but there appears to be sufficient evidence as to the significance of the problem and as to the materiality of the amounts involved to justify extensive research and experimentation directed toward the determination of materiality, and, possibly, the development of a satisfactory solution.

[2] See footnote 1.

METHODS OF MEASUREMENT

Conclusions

(4) *The effects of price fluctuations upon financial reports should be measured in terms of the over-all purchasing power of the dollar—that is, changes in the general price level as measured by a* GENERAL *price index. For this purpose, adjustments should not be based on either the current value or the replacement costs of specific types of capital consumed.*

(5) *The measurement of price level changes should be all-inclusive; all statement items affected should be adjusted in a consistent manner.*

Discussion

It has sometimes been suggested that the current or anticipated replacement cost of specific types of assets be used as a means of measuring the current dollar costs of capital "consumed." This, however, would represent a departure from recorded historical cost and thereby would destroy to a considerable degree the objectivity of accounting. The cost of "consuming" existing capital should be determined irrespective of the intention to replace in kind, to replace with a different type of capital, or not to replace at all. This conclusion appears to rule out, in the determination of income for periodic reporting to stockholders and other non-management groups, the use of either replacement costs or a price index specific to the particular kinds of assets "consumed" by a given corporation.[3]

In contrast, the adjustment of historical dollar costs—the restatement of these costs in current dollars of equivalent purchasing power as measured by a *general* price index—is independent of estimated replacement costs or replacement policy. It differs from the conventional original dollar cost concept only in that it recognizes changes in the value of the dollar and reflects these changes in the amortization of costs and in the determination of periodic income. Its application is independent of possible or probable future price changes, either upward or downward, since only past changes in the value of the dollar are reflected in the adjusted figures.

The use of a measure of over-all price levels as a basis for such adjustment is entirely consistent with the fact that initial investment is made as an alternative to all other possible business uses of funds and, as recovered, again becomes "free" for reinvestment or any other proper business use. While substantial portions of inflowing funds must be used to replace the capital "consumed" if the productive resources of the enterprise are to be maintained, management has considerable freedom of choice in selecting the new assets to be acquired.

The most widely urged objection to the use of price indexes as a means of adjusting past dollar outlays to current dollar equivalents is their alleged inaccuracy. The Committee believes, however, that the errors inherent in index number construction are relatively unimportant where substantial changes in price levels are involved. The existence of such weaknesses in index number construction places practical limitations on the utility of index number adjustments but does not invalidate their use. Specifically, the practical limitations are: (1) adjustments for very small changes in the general price level are ineffective and (2) adjustments tend to become less accurate (because of changes in

[3] The Committee is not unaware of the importance of replacement costs for many purposes, nor is it insensitive to the fact that comparisons of current revenues with the costs of replacing the capital "consumed" in producing such revenues may be highly significant. Financial management necessarily involves the planning of *future* capital receipts and disbursements; and no valid objection can be raised to any form of explanation which enhances the comprehension of such problems on the part of stockholders and other interests external to corporate management.

the real weights of index number elements) as the time period is extended.

Generally speaking, any index number adjustment for change in the value of the monetary unit must be viewed, not as a fact, but as an indication of fact—although quite possibly a more accurate indication than is often possible in other accounting judgments, as, for example, the periodic cost expiration of long-lived assets. That price indexes provide generally acceptable indications of fact is demonstrated by their increasing adoption as bases for wage payment contracts.

The Committee believes that one reasonably accurate and objective instrument for adjusting original dollar costs to reflect changes in the value of the dollar is the Bureau of Labor Statistics index of wholesale prices. Undoubtedly a better index can be developed, and will be as the need becomes apparent. In the meantime, the B.L.S. index will serve reasonably well for experimental purposes; any degree of error introduced by its variation from the "ideal" index may be negligible as compared with the difference, given substantial price changes, between original dollar costs and their current dollar equivalents.

Adjustments made for changes in the value of the dollar should be all-inclusive (i.e., should apply to all statement items). This is held to be essential to full disclosure. One of the most important effects of price level change, for example, may be its impact on the "net balance of fixed-dollar items" (assets fixed in dollar amount minus claims fixed in dollar amount). When the general price level is rising, corporations derive gain (realized or unrealized as may be) from any excess of liabilities and non-participating preferred stock over assets fixed in dollar amount. (When the general price level is declining, this same relation of fixed-dollar items results in loss—realized or unrealized.) This gain (or loss, as the case may be), which typically moves inversely to the real cost of capital "consumed," and which may be of significant proportions, is revealed only by analysis and adjustment of balance sheet items.

METHODS OF DISCLOSURE

Conclusions

(6) *Management may properly include in periodic reports to stockholders comprehensive supplementary statements which present the effects of the fluctuation in the value of the dollar upon net income and upon financial position.*

(a) *Such supplementary statements should be internally consistent; the income statement and the balance sheet should both be adjusted by the same procedures, so that the figures in such complementary statements are coordinate and have the same relative significance.*

(b) *Such supplementary statements should be reconciled in detail with the primary statements reflecting unadjusted original dollar costs, and should be regarded as an extension or elaboration of the primary statements rather than as a departure therefrom.*

(c) *Such supplementary statements should be accompanied by comments and explanations clearly setting forth the implications, uses, and limitations of the adjusted data.*

Discussion

That financial reports should include information supplementary to the primary statements has long been accepted in corporate reporting. Recently there have been included in some annual reports explanations of the effects of price changes upon the reported results. In general, however, references to this subject have been fragmentary and have followed no consistent and uniform pattern. Experimentation may demonstrate that the effects of price level changes are of sufficient importance to justify a more comprehensive treatment. The most practical method of ascertaining the extent of the prob-

lems involved is by means of considered experimentation in the preparation of supplementary analyses. The most promising method of determining the utility and acceptability of alternative results is by means of presentation in corporate reports in the form of supplementary statements.

It is desirable that both the supplementary balance sheet and the supplementary income statement prepared for any given situation be directed to the service of the same ends, and that they therefore be prepared on a consistent basis. The items in the two statements should thus be accorded similar adjustment treatment. This facilitates logical presentation of the respective adjustment amounts, including the adjustment of the proprietary equity.

The primary and the supplementary statements should be clearly reconciled through the medium of accompanying comment and explanation, and the significance, implications, and limitations of the adjusted data set forth through similar media. This will serve the requirements of educational purpose and thereby contribute to a better understanding of our economic environment and to the establishment of more sound business relationships.

It is not proposed that such statements would be covered by the opinion of independent accountants (unless and until adjustment techniques are perfected and their utility proved); in the meantime their status would be that of explanatory material in the preparation of which independent accountants might participate.

SUMMARY

In concluding this statement on *Price Level Changes and Financial Statements,* the Committee seeks to bring into perspective the several coordinate recommendations which it has presented.

In accounting, different purposes may require different types of reports. The traditional balance sheet and income statement, employing historical dollar costs, have proved their usefulness and are of primary importance for many purposes. Reports prepared to reflect fluctuations in the value of the dollar may prove to have substantial usefulness for other purposes.

It is the judgment of the Committee, therefore, that the time has come to give adjusted dollar statements a thorough test. Such statements should now be, and may continue to be, supplementary to the financial statements based on historical dollar cost. During the period of development (or of experimentation, whichever it may prove to be), such statements need not be covered by the independent accountant's opinion although he might assist in their preparation. A number of such experiments by different corporations in different types of business will undoubtedly be required. Only by means of such experimentation can methodology be tested and usefulness proved or disproved.

The Committee has determined the basic premises on which, in its judgment, such tests should be conducted:

(1) Since the supplementary statements are intended to restate historical costs to reflect changes in the value of the dollar and are not concerned with changes in the value of specific assets, a general price level index should be used.

(2) Since the relationships within the balance sheet and within the income statement, as well as between the two statements, are of importance, the adjustments should be comprehensive in scope to the end that the effect of price level changes will be reflected in each item to the exent appropriate.

(3) Since the effectiveness of accounting statements depends on reader understanding as well as on basic usefulness, the two types of statements should be fully reconciled in published reports and should be accompanied by explanations as to their respective natures, usefulness, and limitations.

Statements of the Committee on Accounting Concepts and Standards represent the reasoned judgment of at least two-thirds of its members. They are not official pronouncements of the American Accounting Association or of its Executive Committee.

They shall not necessarily be viewed as stating rules of current professional conduct or procedure. Rather, they state objectives in the development of accounting principles. Some are intended to have immediate applicability, while others forecast the general direction in which accounting may develop.

Committee on Concepts and Standards Underlying Corporate Financial Statements—1951

Willard J. Graham, Chairman
Thomas M. Hill
George R. Husband
James S. Lanham
Stewart Y. McMullen
Maurice Moonitz
Maurice H. Stans

There are listed below the names of the six men who have acted as consultants to this Committee. They have given freely of their time in criticizing successive drafts of this Supplementary Statement and have offered many constructive suggestions for its improvement. It does not follow, however, that they are in complete agreement with the conclusions, nor do they assume responsibility for them.

Samuel I. Broad
James L. Dohr
Howard Greer
Christian E. Jarchow
Earle C. King
William A. Paton

Technical Tax Aspects of LIFO

(Continued from page 750)

must be made in years ending prior to January 1, 1953. Where the adjustment results in refund of tax a claim must be filed by the taxpayer.

Claims for Refund; Additional Assessments

A claim for refund is timely, of course, if it is filed within the period provided by statute for the filing of claims on any grounds; but, in addition, the claim is also timely if filed within three years from the date of filing the return for the year of replacement. Where the adjustment results in a deficiency, the Commissioner must assess it within three years from date of filing the return for the year of replacement or within the statutory period otherwise available. Refunds and deficiencies are made without interest. The taxpayer can obtain an interim or "quickie" allowance of 75% of the refund by filing the proper application.

BOOK REVIEWS

(Continued from page 727)

Industrial Internal Auditing

W. A. Walker and W. R. Davies. McGraw-Hill Book Company, Inc., New York, N. Y., 1951. Pages: vii + 329; $5.00.

The authors of the book are executives of the United States Steel Corporation: Mr. Walker is Vice-President, Accounting, and Mr. Davies is Director, Audit Division.

Its stated purpose is to fill a need for the discussion of internal audit principles with special reference to the requirements of industrial companies.

The first three chapters deal with a discussion of the place of internal auditing in an industrial company, its claim to status as a profession, and the fundamental principles which underlie a sound system of internal control. Differences between public (external) auditing and internal auditing are given.

It is difficult to summarize the next group of five chapters. They are, in this order, Fraud, Types of Audit, Organization of Audit Staff, Reports (of audit), and Planning the Audit. Some of the interesting observations made by the authors are: that function segmentation is the best means of applying internal audit to large industrial companies; and that centralized responsibility for auditing is preferred. They also consider needed aptitude and attitudes of persons engaged in internal auditing.

The book then proceeds from the general to the specific and, in the next four chapters, the balance sheet categories of Cash, Receivables, Inventory, and Accounts Payable are selected to demonstrate the extent of the field in which internal auditing can find opportunities for useful service. Many ideas and suggestions are given.

As the book progresses, the angle of the authors' view moves from that of accounting categories to organizational categories. In chapters 13, 16 and 17, the work of internal auditing is related to the responsibilities of Sales, Production, and Traffic Departments. Here again, are many suggested points of profitable auditing.

Payroll and incentive wage plans receive thorough coverage in chapters 14 and 15. In addition, the Appendix devotes two (of five) problems to the same general topic of payroll.

There is a chapter on construction work, which appealed to the reviewer as particularly useful and timely, in these days of expanded construction activity. The final chapter is a concise account of the auditing incidental to the purchase of a new business.

The appendix is rather extensive: it represents 43% of the total pages in the book. In it are five problems and one solution (it is stated that solutions for the other four are available). The thoroughness with which case study problems are presented is exceptional. The one for construction auditing requires 29 pages to give all the pertinent information, and 17 pages for the report on this audit (the solution). 95 pages are devoted to the other four problems: Payroll Control, Transporation, Incentive Wages, and Shipping Controls.

Perhaps it is indicative of the philosophy of the authors that the chapter on Fraud was given only 9 pages—indicative of a belief that detection of fraud is the least part of internal auditing. A much wider scope of internal auditing is envisioned. It seems clear that, in the opinion of the authors, any action, or lack of action, anywhere in the company, that might affect the profitable operation of the business, is fair game for the internal auditor.

One can readily believe that the authors have had a wealth of experience in auditing the many and varied operations of a large corporation. The profusion of ideas presented by them should be beneficial to anyone engaged in industrial auditing, whether in a large company or in a small one.

A better arrangement in the order of the chapters and of some of the material within some of the chapters would have improved the readability of the book, but the essential merit of the substance outweighs the construction faults by a considerable margin.

J. A. Dowling

Member of Committee on Publications.

Advanced Accounting (Volume I)

By George Hillis Newlove and S. Paul Garner. D. C. Heath and Company, Boston, Mass., 1951. Pages: xiii + 626; $6.00.

Volumes I and II of the authors' Advanced Accounting books assume a previous study of intermediate accounting. Volume II on Reorganizations, Bankruptcies, Fiduciaries, and Partnerships, was published in 1950, and was reviewed in the February, 1951, issue of the New York Certified Public Accountant. Volume I, on Corporate Capital and Income, was published in 1951. In Volume I, the authors state that they "have attempted to treat in a comprehensive manner the many accounting problems arising in the determination and classification of corporate capital and periodic income." A substantial part of the emphasis of the book is therefore on the income statement rather than the balance sheet.

The authors state that their book is intended to serve:

1. Undergraduate and graduate students of advanced accounting.
2. Prospective C.P.A. examinees.
3. Practitioners—accounting and legal.

For undergraduate students, however, this reviewer feels that the book would be heavy reading.

Thoroughly woven into the materials of the book are the bulletins, releases, and monographs of the American Accounting Association, the American Institute of Accountants, and the Securities and Exchange Commission. The book also contains an unusually large number of citations and references to accounting and legal authorities. For orientation purposes several of the chapters (especially materials on income taxes) have sections devoted to judicial decisions,—all adequately referenced to statutes and court decisions.

Chapters 1-6 are devoted largely to problems involved in the determination of corporate proprietorship. The discussion includes such topics as economic and business capital, kinds of capital stock, opening the books of a corporation, organization expenses, treasury stock, stock retirement, surplus and surplus reserves. Chapter 5 is devoted to non-surplus reserves and it commences with a list of 80 of these reserves. Chapter 6 covers "Corporate Dividends: Legal and Accounting Aspects" and the coverage, for an accounting text, is much more complete than usual.

Chapters 7-11 are devoted to detailed coverage of the mathematical and accounting aspects of the evaluation of income and fixed assets (including appraisals, Chapter 11). These chapters give rather detailed coverage of the basic formulas and techniques employed by accountants and appraisers. In evaluating income-producing property, for example, the following methods are presented:

Grimes and Craigue Sinking Fund Method
Morkill Sinking Fund Method
Hoskold Sinking Fund Method
Hoskold-O'Donohue Sinking Fund Method
Compound Interest Actuarial Method
Compound Interest Deferment Method.

These chapters are additionally supported by a set of Compound Interest and Annuity Tables in the appendix.

Chapter 9 relates to fixed assets, their valuation, inclusive of illustrative methods of value amortization.

Chapter 10 is devoted entirely to the problem of evaluating the price to be paid for improved or productive real property. Again, actuarial mathematical formulae are used liberally.

Chapters 12-15 are devoted to the "technical difficulties" (q.v., preface, page v), involved in the determination of periodic business income. This section commences with business and economic income and an explanation of the reasons for the shift of emphasis to income statement reporting. The nature of these four chapters is indicated by their titles:

Chap. 12. Nature of Business Income and Its Realization.

Chap. 13. Periodicity Factor and Business Income.

Chap. 14. Periodicity Factor and Business Income (concluded). This chapter includes such topics as "smoothing" periodic income, installment sales, consignment sales, and construction contracts.

Chap. 15. Foreign Branches and Subsidiaries.

Chapter 16 is devoted to stabilized accounting, a new departure in textbooks but decidedly worth while for the advanced reader.

The book is accompanied by a separately printed *Advanced Accounting Problems Book* (paper cover, page size 8½ x 11), $2.00. There are 265 exercises for class and homework and 172 problems for homework.

It is evident that the authors experienced a heavy work load in their preparation of *Advanced Accounting*, Vol. I, II. Their books represent authoritative additions to the literature of accounting.

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Accountants' Index (Ninth Supplement)

Prepared under the supervision of Miriam W. Donnelly, Librarian. American Institute of Accountants, New York, N. Y., 1951. Pages: 229; $5.00.

This ninth supplement to that most invaluable key to accounting literature—The Accountants' Index—contains the only comprehensive index of accounting literature for the year 1950. The thousands of entries are arranged alphabetically by author, subject and title and comprise a bibliographical research tool which, together with the predecessor volumes, belongs in every accountant's library.

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